Dirham: Journal of Sharia Finance and Economics (JoSFE)
ISSN: 3123-6081, Vol 1, No 1, 2026, 79-88 https://doi.org/10.35912/josfe.v1i2.3801

Corporate Governance of Islamic Banks, Earning Management and Firms Value: A Conceptual Framework

Harsono Edwin Puspita
University of Lampung, Lampung, Indonesia
Harsono_76id@yahoo.co.id

Article History
Received on 24 November 2025
1st Revision on 10 December 2025
2nd Revision on 30 December 2025
Accepted on 8 January 2026

Abstract
Purpose: This study examines the role of corporate governance in mitigating earnings management and its impact on firm value in Islamic banking institutions, emphasizing the function of Sharia Supervisory Boards within a dual governance framework.
Research Methodology: A quantitative panel data approach is employed using observations from Islamic banks over multiple periods. Corporate governance is proxied by board characteristics, ownership structure, audit committee attributes, and Sharia Supervisory Boards. Earnings management is measured using discretionary accrual-based models, while firm value is captured through market-based valuation indicators. Panel regression techniques are applied to analyze direct and indirect relationships among variables
Results: The results indicate that stronger corporate governance mechanisms are associated with lower levels of earnings management, suggesting effective monitoring of managerial discretion. Earnings management is found to negatively affect firm value, implying that capital markets penalize opportunistic financial reporting. Several governance attributes also demonstrate a direct positive relationship with firm value by enhancing transparency and investor confidence.
Conclusions: The study confirms that robust corporate governance, particularly Sharia-based oversight, plays a vital role in constraining earnings management and improving firm value in Islamic banks, supporting agency and signaling theories.
Limitations: This study relies on accrual-based earnings management measures and secondary governance data, which may not fully capture real activity manipulation
Contribution: This research contributes to Islamic finance literature by empirically clarifying the governance–earnings management–firm value nexus and offers practical insights for regulators and practitioners to strengthen governance frameworks in Islamic banking.

Keywords: *Earnings, Firms Value, Islamic Banks, Management*

How to Cite: Puspita, H. E. (2026). Corporate Governance of Islamic Banks, Earning Management and Firms Value: A Conceptual Framework. *Dirham: Journal of Sharia Finance and Economics,* 1(2), 79-88.

1. Introduction

Every investor bases their investment decisions on the sustainable development of firm value while performing their firm(Shafiquea, Kashifb, Haiderc, Zaheerd, & Khan, 2021). (Miles & Van Clieaf, 2017) explained that firm value is a financial measure used to understand the true value of the firm at the current market value, with a marker for long-term financial viability and durability. It also reflects the capital market's expectations regarding future economic profit from current operations, future economic profit from new growth and innovation beyond current operations, and the expected growth, innovation, and discounted future value of economic profit. The manager will prepare real financial reports as accountability for the management of the company's resources entrusted to them.

This financial report must be presented in accordance with generally accepted accounting principles (hereafter mentioned as GAAP). Then, the problem arises with the existence of profit recognition techniques that have the potential to modify profits. There are two techniques for manipulating earnings: accrual alterations and actual deception behavior. These are usually recognized as techniques for manipulating earnings. On the other hand, earnings management is known to be reasonable and legal for management decision-making and reporting, and the intent is to achieve stable and predictable financial results as long as it is appropriate with acceptable standards. This intervention process by management, in other words, "cooking the books" is seen as a strategic tool for optimizing firm value and reducing risk.

Accounting practices meet several different country's accounting system requirements. The need for the above-mentioned requirement is highlighted in several standards for reporting specific to Sharia banks, which should be based on the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Standard and the International Accounting Standards Board (IASB) (Elhalaby, Sarea, Alnesafi, & Al-Absy, 2023). Both accounting standards mentioned that the requirements of representation should be fair, faithful, and just. The firm value itself truly represents the firm's performance when transparency, relevance, reliability, and comparability are upheld by the firm (An, Ran, & Gao, 2025).

To ensure this objective, the AAOIFI requires Islamic financial institutions to have an internal auditor in the form of a Shariah supervisory board. This study proposed a framework of corporate governance and firm value (we proposed the Islamic bank's value, addressing earning management behavior that was unexpected. Thus, the next section reviews the literature related to and elaborates on the theory and conceptual framework. The following section proposes the framework of this study, highlighting the underlying theory. Finally, the conclusion is presented in the last section.

2. Literature review

2.1 Firms Performance, Macro Economic Firms Value

Investors consistently evaluate a firm's financial health by examining key financial indicators, particularly those that reflect how efficiently a firm utilizes its resources. In the banking sector, operational efficiency is essential because banks must be capable of increasing their income while simultaneously minimizing their operating costs. Operational efficiency is commonly measured using the BOPO ratio (Operating Expenses to Operating Income), which reflects management's ability to control operational costs relative to income generated from core banking activities (E. Handayani, Rahmawati, Tubastuvi, & Hapsari, 2021). A lower BOPO ratio indicates higher operational efficiency, leading to improved profitability and better operational performance.

Enhanced profitability serves as a positive signal to investors regarding the effectiveness and future prospects of management. Consequently, BOPO is generally negatively associated with bank firm value, as higher BOPO ratios indicate inefficiency and reduced earnings, which ultimately diminish firm value (D. L. Handayani & Azmiyanti, 2023). In addition to operational efficiency, investors also place significant emphasis on the Capital Adequacy Ratio (CAR), as it reflects a bank's financial strength, risk-bearing capacity, and ability to create sustainable value. CAR measures the proportion of a bank's capital relative to its risk-weighted assets, indicating the extent to which the bank can absorb unexpected losses arising from credit, market, and operational risks.

A higher CAR reduces the probability of bank failure or financial distress, making it a critical indicator of solvency and long-term stability ((B. T. T. Dao & Nguyen, 2020); (Uddin & Barua, 2024). Banks with strong capital adequacy are better positioned to withstand economic downturns without significantly impairing shareholder value, thereby lowering the downside risk and supporting more stable returns. Furthermore, CAR is a core regulatory requirement in international banking frameworks, such as Basel III. Banks that maintain CAR levels above the regulatory minimum face lower regulatory intervention risks, including restrictions on lending, dividend payments, and expansion activities. Regulatory compliance ensures operational continuity and reduces uncertainty related to supervisory actions (Suryanto & Rasmini, 2025).

Well-capitalized banks also have greater flexibility to expand lending, invest in new products, and pursue strategic opportunities, thereby supporting sustainable asset growth and enhancing future earnings prospects, both of which are fundamental to firm valuation ((B. T. T. Dao & Nguyen, 2020); (Uddin & Barua, 2024). Consistently strong CAR levels indicate prudent risk management and effective capital planning. According to signaling theory, this financial strength conveys positive information to the market regarding managerial discipline and long-term strategic orientation, which investors tend to reward through higher firm valuations (B. Dao, 2020)

Beyond capital strength, investors closely monitor Non-Performing Loans (NPL) as a critical indicator of a bank's risk profile, earnings sustainability, and long-term value. NPL reflects the proportion of loans that are in default or close to default, with a high NPL ratio signaling deteriorating asset quality and elevated credit risk. Given that lending is the core activity of banks, asset quality directly determines the soundness of the balance sheet. Therefore, investors use NPL as a primary measure to assess whether a bank's loan portfolio is prudently managed or excessively risky ((Uddin & Barua, 2024);, (Wiadnyani & Artini, 2023)).

An increase in NPL reduces interest income and requires higher loan loss provisions, which directly diminishes net income and weakens earnings stability. Lower and more volatile earnings reduce expected future cash flows, thus negatively affecting firm valuation. As a result, banks with high NPL levels tend to exhibit lower market valuations ((B. T. T. Dao & Nguyen, 2020); (Uddin & Barua, 2024)). Moreover, elevated NPL levels can erode bank capital through credit loss and provisioning expenses. A decline in capital buffers may prompt regulatory pressure to raise additional capital, limit lending activities or restructure operations. For investors, this increases the risk of dilution, lower dividends, and constrained growth potential, further linking NPL to capital adequacy and financial stability ((B. T. T. Dao & Nguyen, 2020); (Uddin & Barua, 2024); (Wiadnyani & Artini, 2023)).

Given the sensitivity of capital markets to credit risk, higher NPL ratios increase uncertainty and raise the risk premium demanded by investors, resulting in lower valuation multiples such as the Price-to-Book Value (PBV) or Tobin's Q (Uddin & Barua, 2024). In addition to firm-specific financial indicators, currency rate fluctuations play an important role in shaping bank firm value, particularly for banks with foreign currency exposure through assets, liabilities or off-balance-sheet activities. Exchange rate volatility increases uncertainty in future cash flows through unrealized valuation changes and realized foreign-exchange gains or losses. According to asset pricing theory, greater uncertainty raises the discount rate applied by investors, thereby reducing the firm's value. Adverse exchange rate movements may also erode capital through translation and transaction losses, weakening capital adequacy ratios and increasing the probability of financial distress and regulatory intervention (Chikwira, 2021)

To mitigate foreign exchange exposure, banks engage in hedging activities that involve additional transactions and monitoring costs. While hedging reduces risk, it may also lower net income and operational efficiency, negatively affecting profitability and market valuation (Lestari & Adekunle, 2024). Moreover, exchange rate volatility is often interpreted as a signal of macroeconomic instability, such as inflationary pressure, external imbalances, and capital flow reversals. In line with signaling theory, such uncertainty conveys negative information to investors, weakening their confidence in the banking sector and reducing firm value. Exchange rate volatility may further exacerbate credit risk for borrowers with foreign currency obligations, reinforcing its overall negative impact on bank firm value (Mujianto & Noviaristanti, 2025).

Given these risks, effective management requires a mechanism that ensures that company resources are managed efficiently and responsibly. This mechanism ensures good corporate governance. Corporate governance establishes the framework for directing and controlling firms by defining decision-making processes, clarifying the rights and responsibilities of boards, managers, shareholders, and other stakeholders, and aligning organizational objectives with long-term value creation. Strong governance mechanisms help monitor and manage risks, enhance transparency, and reduce agency conflicts by aligning managerial actions with shareholder interests.

Agency conflicts often give rise to earnings management practices in which managers exercise discretion in financial reporting to achieve private objectives. Earnings management does not necessarily involve illegal actions; rather, within accounting standards, managers may choose accounting methods or adjust their estimates to influence reported earnings. Prior studies suggest that earnings management is often motivated by the desire to avoid losses, smooth earnings, or meet analysts' forecasts. From a conceptual perspective, discretionary accruals are closely associated with earnings management activities that may ultimately distort firm value.

Overall, BOPO, CAR, NPL, and currency rate fluctuations are the fundamental determinants of bank firm value. Operational efficiency and capital adequacy contribute positively to firm value, whereas elevated credit risk and exchange rate volatility exert downward pressure on valuation (Albi, Komalasari, & Syaipudin, 2025). These relationships are consistent with agency and signaling theories, whereby sound financial performance, effective risk management, and strong governance structures convey positive signals to the market and enhance firm value.

2.2 Management, Corporate Governance and Firm's Value

Each firm has its own resources. Firms must maximize all their resources. Therefore, we need a mechanism to ensure that firm resources are managed efficiently and effectively. Thus, the mechanisms to achieve good corporate governance are the honesty, accountability, and openness of the management of firms. Additionally, information is publicly communicated and upholds charity, justice and fairness. In addition, there is a partnership among boards and owners, together with stakeholders. Corporate governance addresses the proper management, direction, and control of a business. Besides shareholders, the board of directors, and management, which make up the most common structure for businesses, there are also other important structures, rules, and procedures for decision-making purposes; rights and responsibilities of the various participants in the organization (such as the board, managers, shareholders, and other stakeholders); and how rights and responsibilities were given to those participants to achieve firms' objectives. Risks must be monitored and analyzed to maximize firm value (Almutairi & Quttainah, 2017).

According to, corporate governance was recently built expensively with multi-faceted areas combining finance, accounting, law ethics, and economics all at once. They highlighted the World Bank's special definition of corporate governance asthe set of rules and incentives by which the management of a company is directed and controlled…. the way rights and responsibilities are distributed among the board, company management, shareholders, and other stakeholders. However, while policies and documentation are undeniably important, they are not sufficient to ensure good governance. Companies' actions toward promoting corporate transparency and accountability speak louder than words. Thus, this special definition emphasizes the diverse applications of corporate governance.

Managers in ordinary firms initially expected to have their interests referring to the basic principal-agent relationship. Shareholders are known to be interested in reducing discretionary funds for better alignment between the interests of managers and those of shareholders to minimize agency costs. Owners were financially attracted when they were given more influence over the firm's management. These are known to be another corporate governance mechanism for creating harmony between managers and shareholders. Shareholder interests are sustained while reducing agency conflicts. Hence, the earlier mechanism was discovered, and the intentions were expected as contractual arrangements. The aims are to align interests and reduce conflict (Salehi, Tarighi, & Rezanezhad, 2017)).

An effective and efficient management control system can only be achieved if good corporate governance complies with Sharia principles. A general definition of corporate governance is the system by which companies are used to guide, manage, and control businesses. Furthermore, an effort toward this was seen through the issuance of the 2013 Islamic Financial Services Act and the establishment of the 1999 Auditing, Accounting Organisation of Islamic Financial Institution (AAOIFI). In this regard, more regulatory enforcement of banks to comply with Sharia and what is known as the reformation of the regulation of Islamic Financial Institutions (IFI) and capital markets began and spread not only in GCC countries but also to the Philippines, Hong Kong, the UK, and Singapore.

There is an exigent need to conduct good Sharia governance to secure the interests of entities and Islamic finance stakeholders, such as those directly involved in IFI business transactions. These include the IFI board, Sharia Advisors, depositors, shareholders, investors, and regulators. Poor management influences market distortion, the capital market dries up, and the entire financial system eventually goes bankrupt. The functions of the Sharia Supervisory Board (SSB) are important for managing banking institutions. Stated that Islamic banking not only wants to benefit internal stakeholders but also needs to do so according to Fiqh Mu' amalat. Thus, the SSB is an additional layer of governance and an important mechanism to ensure that all transactions conform to Sharia. The SSB needs to be independent and perform as the second board to assure compliance with Sharia in Islamic banks' transactions, more than the general bank board of directors does.

Additionally, the SSB provides suggestions and recommendations, releases fatwas, interprets rules, and thus removes all doubt regarding all stakeholders' concerns (Almutairi & Quttainah, 2017). To fulfill this goal, SSB expertise is the most important consideration in appointing SSB members, especially those with accounting and financial expertise in the Islamic industry. The SSB has the primary duty of inspecting and supervising Islamic bank products and services from the Shariah perspective. The SSB examines and reviews financial contracts, agreements, and other documents to ensure compliance with Sharia principles (Syafa & Haron, 2019). AAOIFI Shariah Standard No. 29 states that accounting and finance knowledge would help SSB understand Islamic bank practices to better control and review Islamic bank financial reports.

Thus, the SSB, as part of the corporate governance mechanism, is responsible for ensuring the reliability of financial statements by observing, regulating, and assessing managers' strategies and firm practices that have implications for all stakeholders, including (Minnis & Sutherland, 2017). According to., (2016), increased moral responsibility pressures on the managers of Islamic banks, similar to firms, are likely to reduce agency costs. Clarity and honesty should be added to any activity that focuses on equality among all stakeholders. They emphasize this aspect as the main characteristic that distinguishes Sharia governance from conventional governance.

Supporting the above, monitoring, control, and evaluation are critical components of efficient and effective banking operations, particularly in Islamic banking institutions. Monitoring is considered functional through intensive monitoring, information collection, and analysis; directing, coordinating, and supervising the bank's operations; and handling their assets, goods, services, and transactions efficiently while conforming to Sharia law that could be performed by the SSB as well as the bank's board of directors (Thoib & Bibi, 2025). Banks need to ensure that they adequately comply with Sharia in their annual reports based on the current and historical events recorded and compiled by the management (Al-Nasser Mohammed & Muhammed, 2017; Aliyu, Yusof, & Naiimi, 2017; Almutairi & Quttainah, 2017).

An adequate expertisement of control that would encourage good corporate behavior was called for. Building faithfulness and dedication among the various stakeholders involved in the organization is needed to avoid earnings modifications to strengthen the credibility of financial statements (Bidabad & Sherafati, 2017). Thus, Islamic law (Sharia) is part of the religious rules to be complied with by Islamic banks for Sharia governance purposes in establishing standards for presenting financial statements ethically and restricting managerial decision-making in earnings management practices (Almutairi & Quttainah, 2017).

2.3 Underpinning Theory And Proposed Framework

2.3.1. The Agency Theory

As explained by agency theory, conflicts between the business owner and manager are manageable as long as their interests are appropriate. However, there are conditions where business objectives are not proper, which can create conflicts of interest (Suttipun, 2018). Shareholders hire managers because they have the expertise to increase the firm's value. Managers cannot utilize their competencies unless they have some discretion in the alternatives of their actions. Nevertheless, managers will optimize shareholder wealth if they are provided with appropriate incentives. For managers to adhere to their firm's values, a managerial remuneration agreement must be formulated to improve their estimated return. The results show that controlled managerial remuneration contract requirements promote the achievement of corporate value.

As a result of the rewards distinction, moral hazard problem, and adverse selection issue, the impact of conflicts of interest could increase agency expenses and decrease firm value. In addition, higher agency costs have an impact on poor management credibility and greater capital costs (Suttipun, 2018). In most situations, firms manage earnings by manipulating the accounting method to influence the user's vision of the financial statement. Accounting principles contain different alternative treatments for the same situations that may manipulate financial information to look alike by providing spurious financial information that does not reflect reality.

2.3.2 The Signalling Theory

The signalling theory is about financial information, where the firm level might manipulate public expectations through earnings announcements, dividend announcements, repurchases, mergers, and several other actions. Firms try to distinguish themselves from low-quality firms by using these actions. If managers know that they can influence investors through the expectation to "control" the market, they might do something more to attain a benefit for themselves. shows how costly a signal is for separating good firms from bad firms. Under asymmetric information between management and investors, signals from firms are important for obtaining financial resources. Ross assumes that managers (the insiders) know the true distribution of firm returns, but reverse with investors.

2.3.3 The Prospect Theory

In general, prospect theory posits four novel concepts in the framework of institutional risk preferences: institutions evaluate financial alternatives according to gains and losses and not according to final wealth (mental accounting); institutions are more averse to losses than they are attracted to gains (loss aversion); institutions are risk-seeking in the domain of losses and risk-averse in the gains domain (asymmetric risk preference); and individuals evaluate extreme events in a sense of overestimating low probabilities and underestimating high probabilities (probability weighting function). Most individuals exhibit a combination of risk-seeking and risk-averse behavior when they receive different return levels.

Banks encounter multiple risks from agency conflicts between depositors and banks, banks and borrowers, and banks and government policies, such as investor protection. Due to the existence of informational asymmetries, Islamic banks must specify a method of financing that maximizes their return while also reducing risk. One of the Islamic principles is justice for human society, which should be reflected in economic transaction processing by financial institutions distributing profit and loss without charging the borrower for the overall cost of the losses. Therefore, owners must conduct a more thorough risk analysis and exercise greater control over the management's utilization of financial resources. Consequently, management, acting as the owner's agent, should avoid activities that lead to asymmetric information because it has detailed information on how resources are used (Mili & Abid, 2017).

2.4 Proposed Framework

The framework as shown in Figure 2 is developed to address the following whether corporate governance moderates the relationship between earning management and firm value, the Islamic bank characteristics, directly influence the value of the bank, and whether Currency Rate Fluctuation (CR) directly influences the bank value (Karianga & Kasingku, 2022). This is in line with the signaling theory that managers give information to shareholders on targeted performance aims by shareholders. As mentioned in agency theory, a conflict between the manager and shareholder will appear if the manager cannot meet the shareholder's expectation to increase their firm value (Kurniawan & Fitriyani, 2023). Furthermore, based on prospect theory, managers will take a safe position by modifying the financial statement figures when the company's performance shows a potential decline so that their performance appears good. The existence of a Sharia supervisory board will supervise managers' policies to increase the bank's value. The role of the Shariah supervisory board is weakened if managers still have the desire to modify financial statement figures (Mujianto & Noviaristanti, 2025).

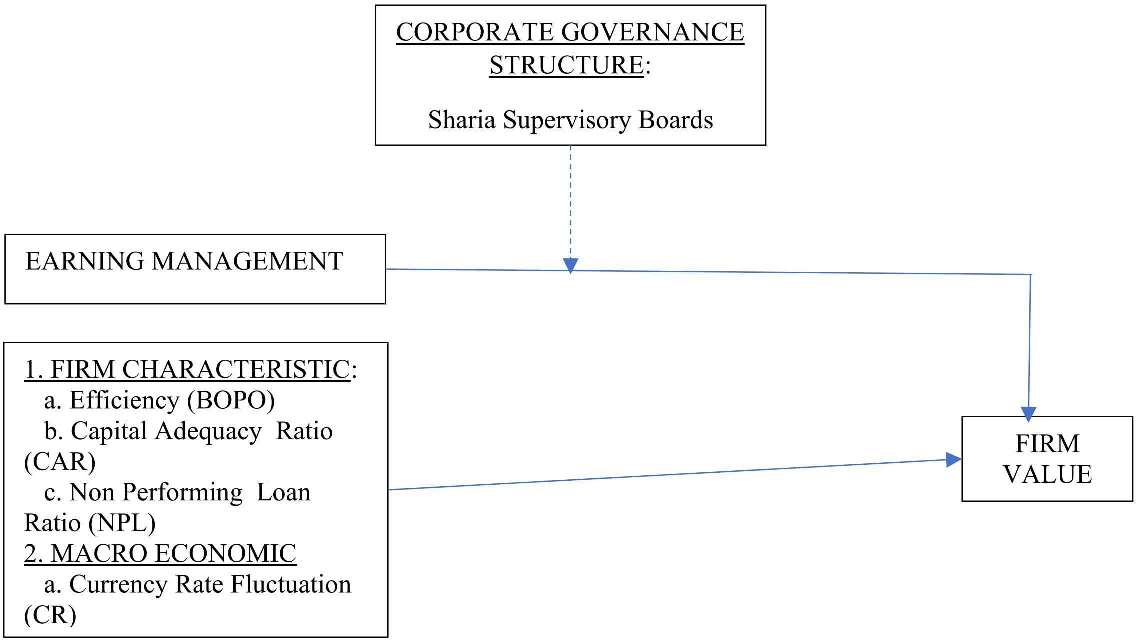

Figure 2. Research Framework

3. Research Methodology

This study employs a quantitative empirical research design to examine the relationship between corporate governance, earnings management, and firm value in Islamic banking institutions in Indonesia. A panel data approach was adopted to capture both cross-sectional and time-series variations, allowing for a more comprehensive understanding of governance dynamics and financial behavior over time.

3.2 Sample and Data Collection

The sample consists of Islamic banks operating in selected jurisdictions where Sharia governance structures have been formally implemented. The observation period covers multiple years to ensure sufficient variability in governance characteristics, earnings management practices and firm performance. Secondary data were obtained from annual reports, audited financial statements, and publicly available regulatory disclosures.

3.3 Variable Measurement

3.3.1 Firm Value

Firm value is measured using market-based indicators, such as the Price-to-Book Value (PBV) or Tobin's Q, which reflect investors' expectations regarding future performance and risk.

3.3.2 Earnings Management

Earnings management is proxied using discretionary accrual-based models, capturing managerial discretion in financial reporting within the boundaries of accounting standards

3.3 Corporate Governance

Corporate governance is measured through board-related characteristics, ownership structure, audit committee attributes, and the presence of Sharia Supervisory Boards (SSB), a distinctive governance mechanism in Islamic banks.

3.3.1 Control Variabels

Firm-specific controls include operational efficiency (BOPO), capital adequacy (CAR), and credit risks (NPL). Macroeconomic conditions are captured through fluctuations in currency rates.

3.4 Empirical Model
Panel regression techniques are employed to examine the direct effect of corporate governance on earnings management and firm value, as well as earnings management mediating role.

4. Results and Discussions
4.1 Descriptive and Empirical Findings
The empirical results indicate that stronger corporate governance mechanisms are associated with lower levels of earnings management, supporting the argument that effective monitoring constrains managerial discretion (Nguyen, Kim, & Ali, 2024). Islamic banks with well-functioning governance structures, particularly those with active Shariah Supervisory Boards (SSBs), demonstrate higher financial reporting quality. Furthermore, earnings management is negatively related to firm value, suggesting that capital markets penalize opportunistic financial reporting behavior. Investors appear to discount firms where earnings quality is perceived to be low, reflecting heightened information risks (Fitriyani, Handayani, & Sari, 2025).

4.2 Corporate Governance and Firm Value
The findings reveal a direct positive relationship between corporate governance quality and firm value. This result supports agency theory, which posits that effective governance reduces agency conflicts and enhances firm performance. The presence of Sharia Supervisory Boards further strengthens governance effectiveness by ensuring compliance with ethical and Sharia principles, thereby improving stakeholder confidence (Wulandari, Sudirja, Setiadi, & Shabrina, 2025).

4.3 Role of Firm Characteristics and Macroeconomic Factors
Operational efficiency (BOPO) and capital adequacy (CAR) are significantly associated with firm value, confirming that efficient cost management and strong capital buffers enhance market valuation. Conversely, higher non-performing loans (NPL) and exchange rate volatility negatively affect firm value by increasing uncertainty and perceived risk.

4.4 Discussion
Overall, the results align with agency, signaling, and prospect theories, demonstrating that governance quality and financial transparency play critical roles in shaping market perceptions. The dual governance structure of Islamic banks provides an additional layer of oversight that mitigates earnings management and supports the creation of sustainable value.

5. Conclusion
This study develops a comprehensive conceptual framework to explain how corporate governance mechanisms influence firm value in Islamic banking through earnings management mediation while incorporating key firm-specific and macroeconomic determinants. The findings conceptually affirm that the value of Islamic banks is shaped not only by financial performance indicators such as operational efficiency (BOPO), capital adequacy (CAR), credit risk (NPL), and currency rate fluctuations, but also by the quality of governance structures that regulate managerial behavior.

Consistent with agency theory, weak governance structures increase the likelihood of opportunistic managerial discretion through earnings management, thereby intensifying agency costs and undermining firm value. In contrast, robust corporate governance, particularly the presence and effectiveness of Shariah Supervisory Boards (SSBs), plays a critical role in mitigating earnings management practices by enhancing monitoring, transparency, and ethical compliance. This dual governance framework distinguishes Islamic banks from conventional institutions and strengthens the credibility of financial reporting.

From a signaling theory perspective, efficient operations, strong capital adequacy, and low credit risk convey positive signals to the market regarding managerial competence and financial stability, resulting in higher firm valuations. Conversely, high BOPO ratios, elevated NPL levels, and exchange rate volatility generate negative market signals by increasing uncertainty, weakening profitability, and increasing perceived risk. Exchange rate fluctuations further exacerbate financial instability through their adverse effects on capital buffers, foreign currency exposure, and borrowers' repayment capacity.

Overall, this study underscores the importance of integrating sound corporate governance with prudent financial and risk management practices to enhance firm value in Islamic banks. The proposed framework offers valuable insights for regulators, policymakers, and practitioners by highlighting the necessity of strengthening Sharia and conventional governance mechanisms to ensure sustainable value creation. Future empirical research should test the proposed relationships across different jurisdictions and regulatory environments to further enrich the Islamic banking literature.

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