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EXPLORING THE RELATIONSHIP BETWEEN BOARD AND SHARIAH GOVERNANCE QUALITY AND COSMETIC ACCOUNTING DURING COVID-19: A CONCEPTUAL STUDY OF MALAYSIAN FINANCIAL INSTITUTIONS

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Abstract:

The COVID-19 pandemic has intensified financial pressures on banking institutions, raising concerns about the integrity of financial reporting practices. This conceptual study explores the relationship between board governance and Shariah governance quality and the prevalence of cosmetic accounting practices among Malaysian financial institutions during the COVID-19 crisis. Anchored in Bank Governance Theory, the study examines how the structure, independence, and effectiveness of both conventional boards and Shariah supervisory boards influence the tendency to engage in cosmetic accounting as a response to external shocks. Malaysia's dual banking system provides a unique context to assess how governance mechanisms within Islamic financial institutions interact with crisis-related incentives to present an enhanced but potentially misleading financial image. The study also considers how the pressures and disruptions caused by the pandemic may have altered the governance-accounting dynamic. By developing this conceptual model, the study aims to contribute to the broader discourse on governance and ethical financial reporting, offering insights for policymakers, regulators, and practitioners seeking to strengthen corporate governance standards in the post-pandemic financial landscape.

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Board Governance, Shariah Governance, Cosmetic Accounting, COVID-19, Malaysian Financial Institutions

Introduction

The global outbreak of COVID-19 and the resulting economic downturn presented unprecedented challenges for businesses worldwide, severely threatening the sustainability of many organizations (Barai & Dhar, 2021). Widely regarded as the most significant health, economic, and social crisis of the century, the pandemic had far-reaching consequences beyond the immediate public health emergency. Efforts by governments to contain the virus, including lockdowns, travel restrictions, and social distancing measures, led to a sharp decline in global economic activity. This, in turn, resulted in rising unemployment, reduced consumer and business confidence, and heightened volatility in financial markets (Zhang, Hu, & Ji, 2020). As a consequence, numerous firms experienced operational disruptions, financial distress, and in many cases, bankruptcy (Lassoued & Khanchel, 2021).

The COVID-19 lockdowns had a significant impact on financial markets and corporate financial performance (Aljughaiman et al., 2023). These disruptions also influenced managerial behaviour. Faced with an unfavourable market environment and increasing pressure to meet performance expectations, many managers may have engaged in cosmetic accounting—the strategic use of accounting discretion to present a more favourable financial position (Ali et al., 2022). During periods of financial distress, such as economic crises or pandemics, firms may adopt cosmetic accounting techniques to mask declining performance in income statements and balance sheets (Rahman et al., 2022).

Cosmetic accounting can be executed through two primary methods: accrual-based practices and real activity-based practices. Accrual-based cosmetic accounting involves manipulating accounting estimates and judgments, such as provisions or depreciation, without altering actual transactions. In contrast, real activity-based cosmetic accounting affects actual business operations such as altering sales timing, reducing discretionary expenses, or changing production levels to achieve desired financial outcomes (Cimini, 2015). Since financial reports are a crucial basis for decision-making by investors, analysts, and other stakeholders, it is imperative that they provide a true and fair view of a firm's financial health. It can be argued that various gaps and flexibilities in financial reporting standards create opportunities for executives to engage in cosmetic accounting (Azizah, 2021). These opportunities were further amplified during the COVID-19 pandemic, as social distancing measures and remote working conditions negatively impacted audit quality and oversight (Albitar et al., 2020). As a result, the reliability of accounting information was compromised, undermining the transparency and authenticity of financial reports and posing risks to the long-term stability and development of enterprises (Chen et al., 2022).

While numerous studies have investigated cosmetic accounting practices during major global events such as the global financial crisis (Cimini, 2015; Filip & Raffournier, 2014) and oil price shocks (Bugshan et al., 2018; Kjærland et al., 2020), there remains a limited body of research

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focused on cosmetic accounting behavior during the COVID-19 pandemic. Recently, research has begun to explore the impact of the pandemic on financial reporting manipulation. Aljawaheri et al. (2021) examined how COVID-19 lockdowns influenced cosmetic accounting practices in Iraq. Similarly, Lassoued and Khanchel (2021) investigated the relationship between the pandemic and cosmetic accounting in European firms, while Xiao and Xi (2021) explored the moderating role of corporate social responsibility in Chinese listed companies' cosmetic accounting behavior during the outbreak. Liu and Sun (2022) also assessed the pandemic's impact on cosmetic accounting practices within the U.S. context.

However, findings across these studies remain inconclusive and, at times, contradictory—particularly regarding the specific types of cosmetic accounting techniques employed during the crisis and the role of financial constraints as a moderating factor. Furthermore, little attention has been given to how these dynamics unfold in emerging markets. To address this gap, some studies have turned to China, given the country's early and severe exposure to the pandemic. COVID-19 was first identified in Wuhan, China, in late December 2019, triggering strict lockdowns that led to widespread economic disruption (Azizah, 2022). According to Liu % Sun (2022) China's economy experienced a downturn of approximately 7% during the initial phase of the outbreak. Despite this context, the differential use of accrual-based versus real activity-based accounting for cosmetics under financial distress has not been thoroughly examined. This points to a significant research gap that future studies should aim to address.

This study is motivated by growing concerns over the adequacy of governance mechanisms in curbing opportunistic financial behavior during crises. While prior research has extensively explored the role of corporate governance in mitigating earnings management and financial manipulation, limited attention has been given to the combined impact of board governance and Shariah governance quality on cosmetic accounting, especially in the face of external shocks like COVID-19. Furthermore, the application of Bank Governance Theory provides a relevant lens to examine how governance structures within financial institutions are designed to align managerial actions with broader institutional goals and stakeholder interests. The primary objective of this conceptual study is to develop a theoretical framework that explores how board characteristics (such as independence, size, expertise) and Shariah governance quality (such as Shariah board independence, qualification, and disclosure practices) influence the extent of cosmetic accounting during the COVID-19 pandemic. By focusing on Malaysian financial institutions, the study contributes to a deeper understanding of how dual governance systems interact in mitigating or enabling cosmetic reporting practices under crisis conditions. This paper is structured as follows: The next section reviews the relevant literature on cosmetic accounting and governance mechanisms in the banking sector. It is followed by the development of the conceptual framework based on Bank Governance Theory. The final sections discuss implications for policy and practice and suggest avenues for future research.

Literature Review

Bank Governance Theory

Bank Governance Theory stems from the broader foundations of corporate governance and agency theory, which focus on mitigating conflicts of interest between managers and shareholders (Laeven & Levine, 2009). However, banks differ fundamentally from non-financial firms due to their high leverage, complex structures, regulatory intensity, and systemic importance. As a result, Bank Governance Theory has evolved to address these unique features by advocating for more stringent and specialized governance frameworks.

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Fatmawati et al. (2020) argued that traditional corporate governance mechanisms are insufficient for banks, given their operational opacity, dependence on public trust, and vulnerability to systemic risk. Karbhari et al. (2020) further emphasized that governance in banking institutions is not solely about enhancing firm-level performance but also about safeguarding public interest, as weak governance in a single financial institution can have widespread implications for the entire financial system.

The theory underscores the necessity of robust board oversight, effective risk management, regulatory compliance, and stakeholder accountability in curbing opportunistic financial behaviors such as cosmetic accounting. This is especially critical during periods of heightened uncertainty, such as the COVID-19 pandemic, when banks face increased financial and operational pressures. In this context, Bank Governance Theory provides a relevant analytical lens to examine how the quality of board governance and Shariah supervisory structures influences the credibility and integrity of financial reporting within Malaysian financial institutions.

Corporate Governance in Malaysia

The Malaysian Code of Corporate Governance (MCCG) is a set of guidelines and best practices designed to enhance corporate governance standards in Malaysia. The MCCG was first introduced in 2000, and significant revisions were made in 2007, 2012, 2017, and 2021. Each revision aims to strengthen the governance framework in response to changing market dynamics and stakeholder expectations. The development of corporate governance in Malaysia has evolved significantly over the past few decades, particularly in response to major economic disruptions and the growing complexity of the corporate environment. Prior to the 1997 Asian Financial Crisis, corporate governance practices in Malaysia were relatively underdeveloped, with concentrated ownership structures, limited board independence, and inadequate disclosure mechanisms. The crisis, however, exposed critical weaknesses in corporate oversight, risk management, and financial transparency, prompting the Malaysian government to prioritize governance reform (Aslam et al., 2023). In response, the Malaysian Code on Corporate Governance (MCCG) was introduced in 2000, laying the foundation for a formalized governance framework for listed companies. This initial code emphasized board responsibilities, audit committee functions, and accountability mechanisms. Over the years, the MCCG has undergone several revisions to strengthen governance standards most notably in 2007, 2012, and 2017. The 2017 revision marked a shift from a rules-based to a principles-and-outcomes-based approach, adopting the “apply or explain an alternative” philosophy, which encouraged companies to adopt governance practices suited to their specific context while maintaining transparency (Khatib et al., 2022). The most recent updates, reflected in the MCCG 2021, focus on board diversity, sustainability governance, and anti-corruption measures aligning Malaysian governance practices with global expectations. Key institutions such as the Securities Commission Malaysia (SC), Bursa Malaysia, and the Malaysian Institute of Corporate Governance (MICG) play vital roles in promoting and enforcing these standards (Uyob et al., 2023). Overall, Malaysia’s governance evolution reflects a gradual but deliberate move towards a robust, transparent, and resilient corporate governance ecosystem, capable of supporting both economic growth and ethical corporate conduct.

Shariah Governance in Malaysia

The development of Shariah governance in Malaysia has been progressive and deliberate, establishing the country as a global leader in Islamic finance. Initially, Shariah compliance in financial institutions was handled informally through in-house Shariah advisors. However, as

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the Islamic finance sector expanded in the 1990s and early 2000s, the need for a more structured governance system became evident (Masruki et al., 2021). In response, Bank Negara Malaysia (BNM) introduced the Shariah Governance Framework (SGF) in 2010 to ensure robust oversight, accountability, and transparency in Shariah-related matters. This framework mandated the establishment of dedicated Shariah Committees, internal Shariah compliance functions, and audit mechanisms within Islamic financial institutions. Recognizing the evolving complexity of Islamic finance, BNM further enhanced the SGF in 2019 by issuing the Shariah Governance Policy Document (SGPD), which refined the roles of the board, senior management, and Shariah committee members. The updated policy emphasized independence, accountability, and integration of Shariah compliance into all levels of institutional governance. It also reinforced the importance of professional qualifications and continuous training for Shariah committee members. Today, Malaysia's dual governance model—combining conventional corporate governance with Shariah oversight—ensures that Islamic financial institutions not only comply with legal and financial standards but also adhere to ethical and religious principles. This comprehensive approach has positioned Malaysia as a benchmark for other jurisdictions seeking to develop their own Shariah governance frameworks. Figure presents the Shariah Governance Framework Model for Islamic Financial Institutions develop by Sori et al., (2015).

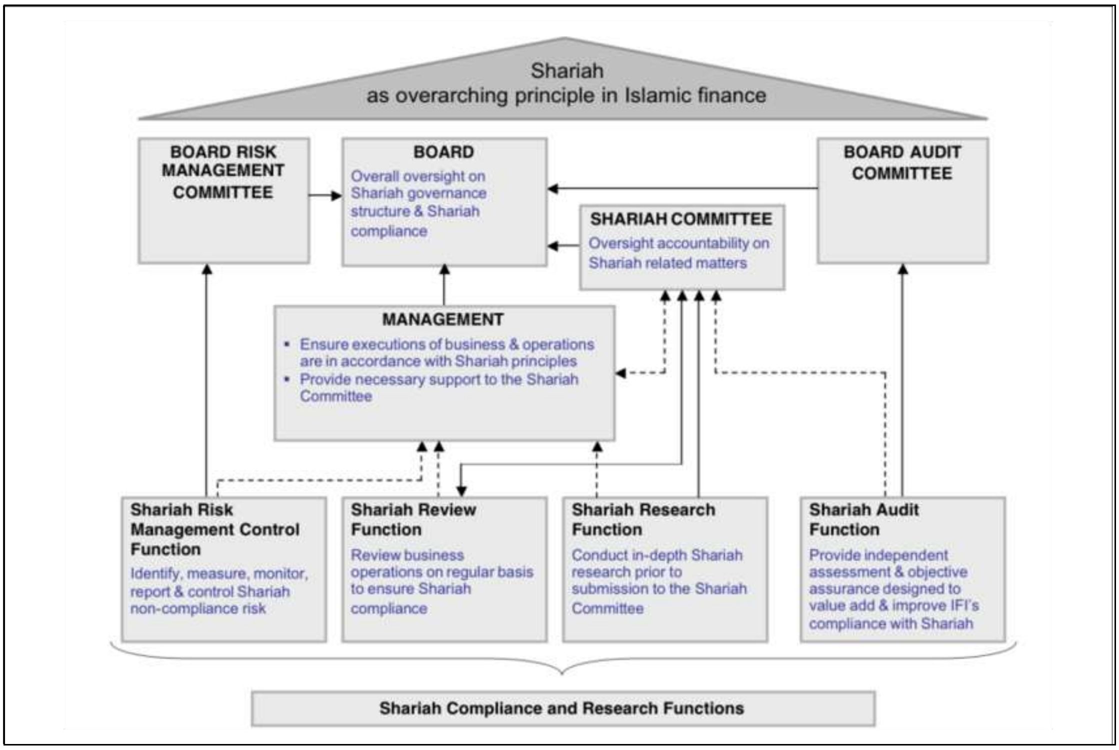

Figure 1: Shariah Governance Framework Model for Islamic Financial Institutions

Cosmetic Accounting
In the context of Islamic financial institutions (IFIs), the issue of cosmetic accounting raises additional concerns due to the dual governance structure involving both conventional corporate governance and Shariah governance. Shariah governance is intended to ensure that all financial activities comply not only with regulatory standards but also with Islamic ethical principles such as transparency, honesty, and the avoidance of deception (Bank Negara Malaysia, 2019). Thus, any practice that misrepresents the true financial state of an institution, even if technically

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legal, may conflict with Shariah principles. Recent studies have emphasized that robust Shariah governance mechanisms, including independent and well-qualified Shariah committees can play a critical role in mitigating opportunistic financial reporting behaviours like cosmetic accounting (Junus et al., 2024).

Cosmetic accounting refers to the manipulation of financial reporting not for direct profit extraction but to enhance the appearance of financial statements, creating a more favorable image of a company's financial health without necessarily violating accounting standards (Rahman et al., 2022). Unlike fraudulent accounting, cosmetic accounting typically involves superficial adjustments such as earnings smoothing, classification shifting, or creative presentation techniques that remain within the bounds of formal rules but distort the economic reality conveyed to stakeholders.

Crucially, cosmetic accounting is not primarily profit-driven. Instead, it is presentation-focused, aimed at influencing stakeholder perceptions such as investors, regulators, or analysts particularly during periods of scrutiny or financial stress. This distinction is important because it highlights that the intent behind cosmetic accounting is reputational management, rather than immediate financial gain. This study makes a critical contribution by shifting the focus from overt fraudulent practices to these subtle yet impactful manipulations, which are often overlooked but can erode trust, compromise transparency, and mask early warning signals of financial instability. By investigating cosmetic accounting through the lens of board and Shariah governance, the study adds depth to our understanding of how governance structures can curb presentation-focused reporting practices that threaten both financial integrity and ethical standards especially in Islamic financial institutions.

The dual-layered governance structure in IFIs, consisting of corporate governance and Shariah governance, serves as a comprehensive mechanism to mitigate such practices. Prior studies have consistently highlighted the role of board characteristics in mitigating earnings manipulation and aggressive reporting behavior. This section elaborates on the theoretical justification for each governance element's role in deterring cosmetic accounting, thereby strengthening hypotheses H1–H5.

Board size refers to the total number of directors serving on a company's board (Uyob et al., 2023). It is a critical aspect of corporate governance influencing the board's effectiveness in monitoring management and strategic decision-making. Larger boards may provide a broader range of expertise and resources, enhancing oversight (Dalton et al., 1999). However, too large a board can hinder communication and slow decision-making. Conversely, smaller boards tend to be more cohesive and decisive but may lack diverse perspectives. Recent empirical evidence suggests an optimal board size balances these factors to improve firm performance and reduce managerial opportunism such as cosmetic accounting (Nguyen & Nielsen, 2021). Specifically, in financial institutions, appropriate board size is crucial given the complexity and risk exposure of the banking sector, enabling effective oversight and governance (Adams & Mehran, 2012; Hsu et al., 2022). Hence, board size is a vital determinant in curbing financial misreporting and enhancing governance quality.

Independent directors play a vital role in providing objective oversight and effective monitoring of management actions, which helps curb opportunistic financial reporting behaviors such as cosmetic accounting (Fama & Jensen, 1983). Recent empirical studies support a negative relationship between board independence and earnings management, indicating that independent directors act as a critical control mechanism in limiting earnings manipulation (García-Sánchez & Martínez-Ferrero, 2020; Klein, 2002). In the context of financial institutions, where transparency, risk oversight, and regulatory compliance are paramount, board independence is particularly essential to reduce managerial discretion and unethical practices (Aluchna & Halka, 2022; Chen & Chen, 2023). Moreover, within Islamic financial institutions, independent board members enhance the alignment of corporate governance with Shariah principles, promoting ethical compliance and integrity in financial reporting (Mohamad & Abdul Rahman, 2021; Haniffa & Hudaib, 2006). Therefore, a higher proportion of independent directors is expected to reduce cosmetic accounting practices by strengthening governance oversight and fostering accountability.

Gender-diverse boards bring varied perspectives and enhance critical thinking, which improves decision-making and monitoring effectiveness (Adams & Ferreira, 2009). Studies have found that increased female representation on boards correlates with reduced earnings management and higher financial reporting quality (Cumming et al., 2022; Gul et al., 2021). Female directors tend to be more risk-averse and ethically conscious, which helps curb opportunistic accounting behaviors (Boulouta, 2013). In financial institutions, gender diversity promotes stronger governance culture and ethical standards, reinforcing transparency and accountability (Aldamen et al., 2020). This is especially important during crises such as COVID-19, where ethical oversight is critical (Aribi & Arun, 2021).

A well-constituted Shariah committee with qualified, independent members ensures that financial reporting complies with both regulatory and Shariah ethical standards (Dusuki & Abdullah, 2007). Effective Shariah governance promotes transparency, honesty, and accountability, which counteracts cosmetic accounting practices (Haniffa & Hudaib, 2007). Recent studies have demonstrated that stronger Shariah committee attributes significantly lower earnings management in Islamic banks (Mohamad & Abdul Rahman, 2021; Junus et al., 2024). The Shariah committee's role extends beyond compliance to embedding Islamic ethical values that discourage financial misrepresentation.

Regular Shariah committee meetings enhance ongoing supervision, allowing timely identification and correction of any non-compliance or aggressive accounting practices (Sulaiman et al., 2017). Higher meeting frequency signals active engagement and commitment to governance, which reduces managerial discretion and opportunities for cosmetic accounting (Ahmad & Haron, 2023). Empirical evidence shows that Islamic financial institutions with frequent Shariah committee reviews report better financial transparency and less earnings manipulation (Hasan et al., 2022). Frequent oversight reinforces adherence to ethical principles required in Shariah governance, strengthening overall financial integrity.

Based on the above argument, the proposed hypothesis of this study is as follows:

H1: Board size is negatively associated with cosmetic accounting.
H2: A higher proportion of independent directors reduces cosmetic accounting practices.
H3: Greater gender diversity on the board is associated with lower cosmetic accounting.
H4: Strong Shariah committee size reduces cosmetic accounting.
H5: Frequent Shariah committee meetings are negatively related to cosmetic accounting practices.

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The Proposed Conceptual Framework

The proposed conceptual framework for this study seeks to examine the relationship between corporate governance quality and cosmetic accounting practices within Malaysian financial institutions, with a specific focus on the moderating role of Shariah governance. The independent variables include four key governance attributes: board size, board independence, gender diversity, and audit committee quality. These elements represent structural and functional aspects of corporate governance that are theorized to influence the extent of cosmetic accounting, which refers to the manipulation of financial presentations without altering the underlying economic reality of transactions. Figure 2 displays the proposed conceptual model of research.

Figure 2: The Proposed Conceptual Model

The variables in this study are carefully selected to reflect both corporate and Shariah governance attributes that may influence cosmetic accounting practices in Malaysian financial institutions. Each variable is defined and measured based on established literature to ensure relevance and empirical clarity.

Cosmetic Accounting serves as the dependent variable and refers to the strategic use of accounting discretion, such as accrual manipulation or financial reclassification, to enhance the appearance of financial statements without altering the firm's actual economic performance (Ali et al., 2022; Liu & Sun, 2022). This type of reporting is presentation-focused rather than profit-driven, often used to influence stakeholder perception, especially during financial distress.

Board Size, measured as the total number of directors on the board, represents the structural capacity of the board to provide oversight. While a larger board may bring diverse perspectives, it may also face coordination challenges, thus its effect on cosmetic accounting is ambiguous (Uyob et al., 2023).

Board Independence is measured as the proportion of independent directors on the board. This variable captures the board's ability to objectively monitor management. Greater independence is expected to reduce the likelihood of opportunistic reporting behaviors, including cosmetic accounting (Uyob et al., 2023).

Board Gender Diversity, defined as the proportion of female directors on the board, reflects the board's inclusiveness and diversity in decision-making. Studies suggest that gender-diverse

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boards are more ethical and risk-averse, potentially leading to lower engagement in cosmetic accounting (Brahma et al., 2020).

From the perspective of Shariah governance, Shariah Committee Size is measured by the number of committee members, as well as their expertise and diversity. A larger, more qualified Shariah committee is presumed to enhance oversight of financial practices to ensure compliance with Islamic ethical standards (BNM, 2019).

Lastly, Shariah Committee Meeting Frequency is used to assess the intensity of Shariah oversight, measured by the number of meetings held annually. More frequent meetings are likely to improve governance effectiveness and reduce the occurrence of misleading reporting practices (Bechihi & Nafti, 2025). Together, these variables offer a comprehensive view of governance mechanisms in Islamic financial institutions and their potential influence on the prevalence of cosmetic accounting. Table 1 summarises the variables and the measurement.

Variable	Description
Cosmetic Accounting	Use of accounting discretion (accrual manipulation, reclassification) to enhance appearance of financial reports (Ali et al., 2022; Liu & Sun, 2022).
Board Size	The number of company's board of directors(Uyob et al., 2023).
Board Independence	Proportion of independent directors; promotes objective monitoring (Uyob et al., 2023).
Board Gender Diversity	Proportion of female directors (Brahma et al., 2020).
Shariah Committee Size	Number, expertise, and diversity of Shariah committee members (BNM, 2019).
Shariah Committee Meeting Frequency	Frequency of meetings; reflects monitoring intensity (Bechihi & Nafti, 2025).

Table 1: Summarises the Variables and the Measurement.

Potential Contribution of The Study

This study offers several significant contributions to both theory and practice by addressing critical gaps in governance literature, especially in the context of Islamic financial institutions during a global crisis.

First, unlike prior governance studies that predominantly focus on conventional earnings management, this research shifts attention to cosmetic accounting, a subtler, presentation-focused practice that is particularly relevant during economic downturns like the COVID-19 pandemic. This shift is crucial because cosmetic accounting, though not necessarily illegal, can undermine stakeholder trust by misrepresenting the financial health of institutions.

Second, the study moves beyond traditional governance variables by integrating both board and Shariah governance attributes, offering a dual-governance lens unique to Islamic financial institutions. While most corporate governance studies examine either conventional boards or isolate Shariah governance, this study proposes a novel, integrated governance framework that reflects the real operational dynamics of Malaysian Islamic banks. This holistic approach enhances our understanding of how ethical and regulatory oversight jointly mitigate accounting manipulation.

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Third, the research introduces and applies Bank Governance Theory, which extends Agency Theory to emphasize the distinct governance needs of banks during systemic shocks. The theory is particularly relevant in the post-pandemic context, where high leverage, public trust, and exposure to systemic risk require stricter governance mechanisms. The inclusion of Shariah principles within this framework is also novel, as it ties ethical accountability to formal governance structures, reinforcing the idea that governance in Islamic finance must ensure both compliance and integrity.

Finally, from a practical standpoint, this study provides actionable insights for regulators, standard-setters, and boards. By identifying specific board and Shariah committee features that deter cosmetic accounting, the findings can inform policies by institutions such as Bank Negara Malaysia, the Securities Commission, and the Shariah Advisory Council to reinforce governance codes, improve transparency, and uphold ethical reporting in the financial sector.

Conclusions

The COVID-19 pandemic has highlighted the vulnerabilities of financial reporting practices under crisis conditions. With mounting pressures to present stable financial positions, some managers may resort to cosmetic accounting—a practice that, while legal, can compromise financial statement reliability and stakeholder trust. This conceptual study proposes that robust board governance (including independence and gender diversity) and effective Shariah governance mechanisms (such as committee size and meeting frequency) can play a pivotal role in mitigating such practices, especially in Malaysia's dual-governance financial environment.

Grounded in Bank Governance Theory, this framework lays the groundwork for future empirical research to test the relationships between governance quality and cosmetic accounting behavior. As financial institutions transition into a post-pandemic landscape, the study underscores the need for resilient governance mechanisms that can sustain transparency under pressure. Future research could explore cross-country comparisons between Islamic and conventional banks to examine how different governance ecosystems influence accounting practices during periods of uncertainty. Ultimately, this study aspires to enhance corporate transparency, support ethical financial practices, and contribute to the evolving landscape of governance in both conventional and Islamic financial institutions.

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