

# Does ESG Disclosure Affect Profitability?

## Evidence from Shariah-Compliant Firms in Indonesia and Malaysia

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### Abstract

Sustainability issues and the implementation of Environmental, Social, and Governance (ESG) disclosure have become a major focus in the global business environment, including among Shariah-compliant firms. Although many firms have adopted sustainability initiatives, the contribution of ESG disclosure to financial performance remains debated. This study aims to examine the effect of ESG disclosure on the profitability of Shariah-compliant firms in Indonesia and Malaysia. Leverage, earnings management, and firm size are included as control variables. The sample consists of Shariah-compliant firms listed on the Indonesia Stock Exchange and Bursa Malaysia. The analysis employs multiple regression using a fixed effect model approach. The findings reveal that, overall, ESG disclosure negatively affects profitability in both the combined sample of Indonesia and Malaysia and the Indonesian sample individually. In contrast, among Shariah-compliant firms in Malaysia, ESG disclosure does not have a significant impact on profitability, whereas earnings management shows a positive effect. These results highlight the need to enhance the substance of sustainability disclosures to better support financial value creation. This study contributes to the extension of agency theory and signaling theory within the context of Shariah-compliant businesses and opens avenues for future research on strengthening governance practices based on Islamic ethical values.

**Keywords:** ESG disclosure; profitability; shariah compliance; agency theory; signaling theory

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### Introduction

Growing global awareness of environmental, social, and governance issues is driving companies to pay greater attention to non-financial aspects of their operations. A survey of 1,000 chief executive officers (CEOs) in various countries conducted by the United Nations Global Compact shows that 93% of respondents consider ESG to be a very important factor in organizational success (United Nations Global, 2019). In line with these findings, investors are also increasingly viewing ESG as a factor that provides long-term financial benefits, as reflected in market appreciation for companies that are active in promoting social and environmental well-being (Pulino et al., 2022). Various stakeholders, including investors, employees, customers, suppliers, and regulators, now demand that companies manage ESG risks more systematically and transparently. Companies have responded to this pressure by disclosing their sustainability performance through three main pillars: Environment, Social, and Governance. However, from an internal perspective, allocating resources to ESG initiatives requires significant investment, sparking debate about the extent to which they contribute to a company's financial benefits.

In response to this growing pressure, companies are not only adjusting their internal strategies but also beginning to adopt ESG as part of their core business practices. ESG disclosure is now an increasingly adopted strategy by public companies to build credibility, strengthen relationships with stakeholders, and maintain competitiveness amid industry dynamics (Olsen et al., 2021). While some companies integrate sustainability practices as part of their competitive advantage strategy, others implement them as standard procedures that evolve gradually (Ioannou & Serafeim, 2019). This trend is reinforced by the increasing number of companies voluntarily adopting ESG practices, supported by initiatives from international organizations and sectoral bodies to build a sustainable global economy (Yoon et al., 2018). Additionally, both companies and investors are increasingly incorporating ESG considerations into their strategic decision-making processes (Eccles & Youmans, 2015). The issue of ESG's impact on company value and profitability has become a central focus in academic circles, with many studies showing positive results, although some continue to support the traditional view that the primary focus of companies is to maximize shareholder profits (Jitmaneroj, 2016).

Global business environment changes have driven ESG disclosure to be viewed not merely as a reporting obligation but as a critical strategy in strengthening a company's legitimacy in the eyes of stakeholders. Non-financial information such as ESG disclosure reflects a company's commitment to sustainability and serves as a positive signal regarding future financial performance prospects (Buallay, 2019). Through transparent disclosure, companies build credible communication mechanisms, strengthen public perception, and enhance trust in the integrity and operations of the company (Melinda & Wardhani, 2020). As a result, ESG disclosure has become an integral part of reputation strategy with the potential to increase the value and competitiveness of companies in the long term.

Strengthening operational sustainability and corporate governance effectiveness is also increasingly clarified through implementing ESG. This practice helps companies minimize negative impacts on the environment and society, while optimizing internal governance ((Alsayegh, M.F et al.,2020) In addition, ESG provides important information on dominant environmental, social, and governance issues, making it a crucial factor to be considered alongside financial performance in strategic decision-making (Bassen, A.; Kovács, A.M. 2020. In the modern business framework, ESG serves not only as non-financial reporting, but also as a strategic instrument to drive the creation of sustainable value for all stakeholders.

Although ESG is increasingly adopted, most companies in developing countries have not implemented it substantially. Many of them only engage in formal compliance without substantial commitment to sustainability principles and without transparently disclosing actual expenditures related to social and environmental initiatives (Rahman et al., 2021; Zhou et al., 2022). Concerns about increased operational costs and potential declines in financial performance are the primary reasons behind their reluctance to implement ESG (Rahman et al., 2021). Full compliance with ESG standards is generally only considered when companies see potential direct financial benefits. In this context, McWilliams and Siegel (2011) emphasize that what is more crucial is not only the extent to which companies implement ESG, but how ESG is used strategically to improve financial performance.

Research on the relationship between Environmental, Social, and Governance (ESG) and corporate financial performance draws on various theories developed in the disciplines of organization, management, and finance. Although numerous theories have attempted to explain this relationship, there remains a theoretical gap in fully understanding how ESG disclosure influences corporate financial performance. Several theories support the view that ESG practices positively contribute to improved corporate performance. Signaling Theory argues that ESG disclosure serves as

a positive signal to the market regarding a company's commitment to sustainability (Spence, M .1973). Meanwhile, Suchman's (1995) Legitimacy Theory states that companies use ESG as a means to obtain, maintain, and strengthen their social legitimacy. Consistent with this, Freeman's (1984) Stakeholder Theory emphasizes that meeting stakeholder expectations through ESG practices is key to building strong external relationships and driving better financial performance. Support for the positive influence of ESG is further reinforced by Slack Resources Theory, which argues that excess resources enable companies to fund social and environmental initiatives, thereby enhancing their reputation and performance (Abdi et al., 2022). Additionally, the Resource-Based View (RBV) adds that unique and difficult-to-imitate ESG capabilities can serve as a source of long-term competitive advantage for companies (Gaur et al., 2011).

However, several other theories question the effectiveness of ESG initiatives in improving financial performance. Agency Theory, proposed by Jensen and Meckling (1976), argues that investments in ESG carry the risk of diverting resources from the company's primary objective maximizing shareholder wealth thereby potentially reducing corporate efficiency. This view is reinforced by Shareholder Theory, popularized by Friedman (1970), which asserts that involvement in social and environmental activities can only be justified if they directly increase company profits.

These theoretical differences are also reflected in empirical research findings, where evidence on the impact of ESG on company financial performance shows diverse results and has not yet reached a consensus. Empirical research on the impact of Environmental, Social, and Governance (ESG) on corporate financial performance reveals diverse and inconsistent findings. Some studies have found that ESG implementation contributes positively to financial performance. Buallay (2019) found that ESG significantly influences profitability, measured through ROE and ROA. Similar findings were reported by Mohammad, W. M. W., & Wasiuzzaman, S. (2021) who stated that ESG initiatives can improve company performance. Bruna et al. (2022) also found that ESG has a positive impact, although the relationship is non-linear, meaning that financial benefits do not always increase with higher ESG scores. However, there are also studies that show the opposite results. Rahman et al. (2023) and Giannopoulos (2022) found that ESG has a negative impact on profitability, in line with Veeravel's et al. (2024) findings that ESG investments can actually reduce financial performance. In addition, several studies also found that ESG does not have a significant impact on profitability. Lin, W. L et al. (2019) showed that good CSR activities do not always improve company performance, while Firmansyah et al. (2022) and Atan (2018) found that ESG does not significantly affect ROE. The diversity of these results indicates that the relationship between ESG and financial performance is influenced by many factors, such as industry sector, geographical location, and the measurement methods used, thus requiring further research to gain a deeper understanding.

Along with the rapid development of ESG research in conventional companies, attention to the implementation of ESG in companies that comply with Sharia principles is also increasing. Sharia stocks are securities that have gone through a screening process according to Islamic principles by competent authorities, such as the Financial Services Authority in Indonesia and the Securities Commission in Malaysia. Islamic companies are expected to implement more ethical management practices, including in terms of transparency and accountability, that are conceptually in line with ESG values (Lee & Isa, 2022; Ali & Al-Owaihan, 2008). Thus, testing the influence of ESG on the performance of Islamic companies is important to understand the effectiveness of sustainability practices within a governance framework that is in line with Sharia principles.

Several studies have shown that ESG disclosure has a positive impact on the performance of Islamic companies. Erragragui and Revelli (2016) found that ESG integration does not reduce the returns of sharia stock portfolios. Khattak et al. (2020) found that sustainability performance disclosure significantly improves a company's financial performance, particularly Return on Assets (ROA) and Return on Equity (ROE). They also noted that the impact of ESG disclosures is stronger on Sharia-compliant companies than on non-Sharia-compliant companies, where the impact was even found to be negative on non-Sharia-compliant companies. Peng and Isa (2020) and Lee and Isa (2022), also show that ESG scores have a positive effect on financial performance, including the cash structure of Sharia-compliant companies. The Shalhooob study (2025) shows that stakeholders view a positive relationship between ESG disclosure and the performance of Islamic companies, especially when ESG practices are aligned with Islamic financial principles. Although the study focused on perceptions, rather than actual measurement of financial performance, these findings indicate that the integration of ESG and Maqasid al-Shariah has the potential to increase trust, corporate responsibility, and investment attractiveness, which indirectly reflects a positive contribution to a company's performance.

However, there are also studies that report negative effects. Firmansyah et al. (2023) found that ESG disclosure in aggregate was negatively related to market valuation (Tobin's Q) and was insignificant to ROE in Islamic companies in Saudi Arabia. Pujiastuti et al. (2024) also show that ESG has a negative impact on the ROE of Islamic companies in Indonesia, even though it has a positive correlation with stock prices. Similar findings were conveyed by Al Azizah and Haron (2024) who noted that ESG initiatives are not necessarily aligned with improving accounting-based performance in Islamic companies. Meanwhile, another study shows that ESG disclosures have no significant effect on financial performance. Alghafes et al. (2024) found that ESG has not been substantially integrated with Sharia principles and has not had a real impact on the performance of Islamic banks in the GCC region. Fakhrunnas et al. (2025) even found that although ESG has a positive impact on the conventional banking sector, its effect is actually negative on Islamic banks

Therefore, it is important to empirically examine whether ESG disclosures contribute to improving the financial performance of Islamic companies. Although Islamic companies are expected to have a commitment to sustainability principles, previous research has shown inconsistent and still limited results, especially in cross-border contexts in developing regions. This study specifically aims to examine the influence of ESG disclosure on the financial performance of Islamic companies listed in Indonesia and Malaysia, in order to provide a deeper understanding of the relevance of ESG in the context of modern Islamic finance. Thus, this study is expected to enrich the ESG literature and make a practical contribution to investors and regulators in Muslim-majority countries.

## **Literature Review**

Environmental, Social, and Governance (ESG) reflects non-financial aspects that demonstrate how companies manage sustainability issues in their operations. Today, this information is gaining increasing attention as an important factor in the company assessment process (Bassen & Kovács, 2008). Although ESG disclosure has not yet fully adhered to standards such as financial reporting, some experts argue that this information plays a central role in helping companies adapt to external changes and support strategies for achieving competitive advantage (Galbreath, 2013). Through the ease of access to ESG data, many studies use ESG scores as a proxy for assessing corporate sustainability performance (Drempetic et al., 2019).

In its application, ESG scores are typically categorized into three main pillars: environmental, social, and governance, with each company receiving separate assessments for each aspect. Environmental scores, for example, measure indicators such as CO<sub>2</sub> emissions and waste volume. Social scores assess a company's efforts in areas such as equality, human rights protection, and labor conditions, while governance scores cover aspects such as shareholder rights protection and the implementation of anti-corruption practices. Overall, ESG scores are provided by various international data agencies, including ASSET4, SAM, Bloomberg, and Thomson Reuters Eikon (Dorfleitner et al. 2015), with this study utilizing data from Eikon as a reference.

Furthermore, Refinitiv's ESG score combines social, economic, and environmental criteria to make it easier for investors to assess a company's sustainability performance and identify low-risk investment opportunities. This ESG measurement assesses a company's relative performance, commitment, and effectiveness based on voluntarily reported data. Refinitiv's ESG score is divided into three main pillars: The Environmental Pillar (EPS), which assesses resource use, emissions management, and product innovation; the Social Pillar (SPS), which covers labor, human rights, community, and product responsibility; and the Governance Pillar (GPS), which evaluates management structure, shareholder rights protection, and corporate social responsibility strategy.

However, ESG disclosure practices across companies still show significant variation. This disclosure varies not only in terms of the scope and depth of information but also in the quality, clarity, and consistency of the reported data (Elzahar et al., 2015). In line with these findings, studies by Ioannou and Serafeim (2017) and Reverte (2009) reveal that there are significant differences in ESG disclosure among companies and across countries. One factor contributing to this high level of variation is the freedom management has in determining the content, format, and methods of ESG reporting without uniform global standards. This situation leads some companies to engage in symbolic disclosure to gain legitimacy, while others strive to build long-term credibility through comprehensive reporting.

This difference in approach is further highlighted by the findings of Van Duuren, E , (2016) who identified significant differences in European managers' perceptions of ESG. Some managers view ESG as an integral part of long-term business strategy and innovation, while others see it as an additional burden to be fulfilled solely to meet external pressures. This heterogeneity of views illustrates that, to date, there is no universal standardization in ESG disclosure practices, which is greatly influenced by factors such as corporate strategy, organizational culture, the level of stakeholder pressure, and the regulatory context of each country. Furthermore, studies by Elzahar et al. (2015), Ioannou and Serafeim (2017), and Reverte (2009) show that differences in culture, organizational strategy, and external pressure contribute to variations in the effectiveness of ESG disclosure across different contexts.

Given the high variation in ESG disclosure practices, studies on the relationship between ESG and financial performance need to take this diversity into account in order to provide a more accurate understanding. Differences in the depth, quality, and scope of ESG disclosure have the potential to influence how investors, analysts, and other stakeholders assess a company's overall sustainability performance and financial performance.

### **Sharia Compliance Firms**

Sharia stocks are stocks of companies that meet strict criteria in accordance with Islamic sharia principles, which are regularly selected by the Securities Commission Malaysia through a quantitative and qualitative screening process. Quantitative screening includes the exclusion of companies

operating in sectors deemed non-halal, such as conventional banking, conventional insurance, gambling, production of alcoholic beverages, pork products, entertainment not compliant with Sharia, interest income from conventional instruments, and tobacco products, with a very limited tolerance for non-permissible income contributions. Additionally, financial criteria such as the debt-to-total-assets ratio are also used as benchmarks for eligibility. From a qualitative perspective, companies must also have a positive reputation and core activities deemed important and aligned with public interests. Studies in the Malaysian context indicate that sharia-compliant companies tend to have higher ESG (Environmental, Social, and Governance) scores compared to non-sharia companies, reflecting better management quality and a focus on sustainable business practices. This combination of ESG and sharia screening not only ensures alignment with Islamic values but also enhances company financial performance, making sharia stocks an attractive investment option for investors prioritizing ethical and sustainable aspects (Lee and Isa, 2022; Ayedh et al., 2019; Azam et al., 2019)

### **Previous Research on the Impact of ESG on Profitability**

The findings of research on the impact of Environmental, Social, and Governance (ESG) on company financial performance can generally be classified into three main groups. First, a number of studies indicate that the implementation of ESG contributes positively to improved financial performance. Second, there are studies that find that ESG practices actually have a negative impact on company performance. Third, several other studies report mixed results, where the relationship between ESG and financial performance is inconsistent or non-linear. This sub-chapter will systematically describe each of these groups of findings.

### **Research Findings on the Positive Relationship between ESG and Financial Performance:**

Most previous literature indicates that Environmental, Social, and Governance (ESG) performance has a positive relationship with corporate financial performance. Various studies have found that the implementation of ESG practices can reduce equity costs, strengthen corporate reputation, drive higher returns, and expand market share (Pulino et al., 2022; Waddock & Graves, 1997; Zhao et al., 2018). Country-based studies conducted in Germany, South Korea, China, India, and the United States (Yoon et al., 2018; Zhao et al., 2018; Dalal & Thaker, 2019) further confirm that ESG scores are positively correlated with firm value and profitability. Cross-country studies by Xie et al. (2019), Bhaskaran et al. (2020), De Lucia et al. (2020), Naeem et al. (2022) dan Aydoğmuş, M., et al. (2022) also found that companies with strong ESG performance tend to have higher market value and operational performance. These findings are reinforced by Chairani and Siregar (2021) in the ASEAN region.

### **Research Findings with a Negative Relationship between ESG and Profitability**

On the other hand, several studies suggest that engagement in ESG practices can have a negative impact on financial performance. Research such as that conducted by Achim & Borlea (2014) revealed that ESG worsens accounting performance, despite improving market performance. Studies in the UK (Brammer et al., 2006), Italy (Landi & Sciarelli, 2019), and Canada (Folger-Laronde et al., 2020) reinforce the evidence that companies with high ESG scores are not always better at handling market pressures. Additionally, research in emerging markets by Garcia and Orsato (2020) found that capital constraints make ESG investments negatively impact ROA and free cash flow. Other studies, such as those conducted by Mittal et al. (2008) dan Crisóstomo et al. (201) also reported that allocating

resources to sustainability initiatives may reduce shareholder value, thereby having a negative effect on financial performance.

### **Research Findings with Inconsistent or Mixed Relationships between ESG and Financial Performance:**

Some other studies reveal that the relationship between ESG and financial performance does not show a consistent pattern. Research such as Ching et al. (2017), Esteban-Sanchez et al. (2017), and Lin et al. (2019) found that higher ESG scores do not always correlate with improvements in accounting or market performance. In fact, some studies note an inverted U-shaped relationship or an asymmetric relationship (Barnett & Salomon, 2012; Jayachandran et al., 2013). Research in Malaysia (Atan et al. 2019), Turkey (Saygili et al. 2021), and Norway (Giannopoulos et al., 2022) also showed mixed results, with some ESG aspects strengthening market value but reducing profitability. Findings from Behl et al. (2022) in the Indian energy sector and Lopez-de-Silanes et al. (2020)

Based on the literature review above, this study then tests the hypothesis regarding the relationship between ESG and financial performance.

Hypothesis : ESG score have a positive and significance impact on profitabilitas

### **Methods**

This study analyzes the impact of ESG scores on company profitability in sharia stocks in Indonesia and Malaysia with a research period from 2015 to 2023. ESG scores were obtained from the Eikon Refinitif database, and financial data such as profitability, leverage, company size, and data needed to calculate profit management were obtained from company annual reports. A total of 429 individual observations of Islamic companies were collected. The dependent variable in this study is profitability, proxied by return on equity (ROE), with the independent variable being the ESG score. Control variables include leverage, profit management, and company size. This study employs panel data regression with the best-fitting Fixed Effects Model, with the regression equation:

$$ROE_{i,t} = \alpha_0 + \alpha_1 \text{ESG score} + \Sigma \text{control}_{i,t} + \varepsilon_{i,t}$$

Where, ROE is a proxy for company i's financial performance in year t, ESG score is a proxy for company i's ESG disclosure in year t, control is a control variable consisting of size, leverage and earnings management and  $\varepsilon$  is the standard error of regression.

In this study, the selection of the best model for panel data analysis is carried out through a series of model specification tests,

In a multi-country study further confirm that the influence of ESG on financial performance is complex and depends on specific contextual factors of the company and the market.

Namely the Chow test and the Hausman test. The Chow test is used to determine whether the pooled least squares (PLS) model or the fixed effect model (FEM) is more appropriate. Furthermore, to ascertain whether the FEM is superior to the random effect model (REM), the Hausman test is conducted. In addition, classical assumption tests are also carried out, namely normality test, autoregression test, hetereskedaticity test and multicollinearity test.

## Result and Discussion

### Descriptive Statistics

Descriptive statistics can be seen in table 1, below

Table 1. Descriptive Statistics

Variabel	Mean	St. Dev	Min	Max
Indonesia+Malaysia				
ESG score	51.27447	17.455	6.736	91.651
ROA	.0692	.0833	-.2052	.5096
Earning Mgt	.1313	.7458	-1.6076	6.0014
Leverage	.4985	.1944	.0076	1.2988
Size	27.3401	4.0045	20.9767	33.7306
Indonesia				
ESG score	48.954	18.797	6.736	87.765
ROA	.0882	.09505	-.1381	.4578
Earning Mgt	.2717	1.0305	-1.607	6.001
Leverage	.4918	.1979	.1141	.9947
Size	31.331	.9239	28.989	33.7306
Malaysia				
ESG score	53.543	15.796	11.778	91.651
ROA	.0510	.0658	-.20519	.50961
Earning Mgt	-.00174	.2112	-.37095	1.038
Leverage	.5039	.1907	.7621	1.298
Size	23.570	1.037	20.976	26.050

*Sources : Stata Data Processed Result*

### Selection of The Best Model

This study analyzes the effect of ESG scores on the performance of sharia stocks in Indonesia and Malaysia. Therefore, the best model was selected for Indonesia and Malaysia (Full) data, Indonesia data, and Malaysia data.

The results of the model testing for Indonesia and Malaysia can be seen in Table 2. The Chow test was conducted to select the best model between the Common Effect Model and the Fixed Effect Model. The chow test results obtained Prob>F results are 0.0000 and this value is smaller than alpha 5% (0.05) so that the model chosen is the Fixed Effect Model (FEM). Furthermore, to select a model between the FEM and the Random effect Model (REM), the Hausman test was carried out. From the Hausman test obtained Prob>chi2 of 0.0000 which is smaller than alpha 5% or 0.05, so the FEM model is better than REM. Because the selected model is FEM, a classic assumption test must be carried out on the FEM model, namely normality test, heteroscedaticity test, multicollinearity test and autocorrelation test

Table 2. Chow Test and Hausman Test

Testing	Test	Prob	Decision
Chow Test	Cross-section F	0.000	FEM
Uji Hausman	Cross-section random	0.000	FEM

*Sources: Stata Data Processed Result*



## Classical Assumption Test

The classical assumption test is necessary in this study because the selected model is FEM. The classical assumption test was also conducted for the combined data of Indonesia and Malaysia, as well as for the separate data of Indonesia and Malaysia. The normality test used the Shapiro walk, the multicollinearity test used VIF, the heteroscedasticity test used Breusch-Pagan, and the autocorrelation test used the Woldridge test.

## Normality Test

The normality test for the combined Indonesian and Malaysian data and the separate Indonesian and Malaysian data yielded the same results, indicating that the data were not normally distributed. The Shapiro Wilk test resulted in a probability > Z of 0.000, which is less than the alpha level of 5%. This indicates that the data were not normally distributed, violating the classical assumption.

## Heteroscedasticity Test

The heteroscedasticity test using the Breusch-Pagan test yielded a probability > chi-squared of 0.0000. This value is less than the alpha level of 5%, indicating the presence of heteroscedasticity. Heteroscedasticity is also present in the Indonesian and Malaysian data individually. The presence of heteroscedasticity indicates a violation of the classical assumption for both Indonesia and Malaysia.

## Autocorrelation test

The autocorrelation test was conducted using the Woldridge test. From the results of the autocorrelation test, Prob>z was 0.0000, which is smaller than alpha 5%, indicating autocorrelation. Similarly, the Indonesian and Malaysian data did not meet the classical assumption.

## Multicollinearity test

The results of the multicollinearity test show that the VIF for all variables is less than 10. Because VIF is small, there is no multicollinearity between the independent variables in this study. Similarly, the data for Indonesia and Malaysia do not show any multicollinearity. These results indicate that multicollinearity does not violate the classical assumption.

Table 3. Normality Test

Variabel	Indonesia + Malaysia		Indonesia		Malaysia	
	VIF	1/VIF	VIF	1/VIF	VIF	1/VIF
Size	1.03	0.973353	1.28	0.78154	1.05	0.954311
ESG	1.02	0.980668	1.22	0.820522	1.03	0.969777
Earning Mgt	1.01	0.98141	1.09	0.921603	1.02	0.982552
Leverage	1.00	0.995740	1.02	0.976628	1.02	0.983284

*Sources : Stata Data Processed Result*

## Results of FEM regression with robust standard error

The best model for Indonesian and Malaysian data was selected using the Chow test and Hausman test, and the selected model was the Fixed Effect Model (FEM). The results of the classical assumption test showed a violation of the classical assumption, where the data was not normally distributed, there were symptoms of heteroscedasticity and autocorrelation, so robust standard error was used to eliminate bias. Therefore, the regression analysis in this study used FEM with robust standard error.

The table below shows the regression results for Indonesian and Malaysian companies.

Table 4. Regression Model Test Result

ROA	INDONESIA+MALAYSIA	INDONESIA	MALAYSIA
ESG	-.000477 -2.17	-.00108 -2.22	-.0004 -1.57
Leverage	-.176 -2.24	-.3453 -2.90	-.0346 -0.65
Size	.0252 1.17	.0396 1.41	.4241 1.37
Manaj. Laba	-.0186 -3.79	-.0191 -11.68	.0271 2.75
_cons	-.5057 -0.85	-.9251 -1.08	-.9115 -1.22
R-Square	0.0948	0.2113	0.0538
F stat	0.0015	0.0000	0.0000

*Sources: Stata Data Processed Result*

Based on the results of the Fixed Effect Model (FEM) regression with robust standard error on the combined data of companies in Indonesia and Malaysia, it was found that the ESG variable has a negative coefficient of -0.000477 and is significant at the 5% level ( $p = 0.033$ ). This indicates that an increase in ESG scores is associated with a decrease in Return on Assets (ROA), suggesting that investments in ESG practices have not yet yielded direct positive impacts on short-term profitability in this region. The leverage variable also shows a significant negative effect on ROA, with a coefficient of -0.176 and a p-value of 0.029, indicating that an increase in the proportion of debt in a company's capital structure can reduce profitability. Meanwhile, profit management has a negative coefficient of -0.0186 and is highly significant ( $p < 0.001$ ), indicating that aggressive profit management practices can harm a company's financial performance. The firm size variable does not show a significant effect on ROA, with a coefficient of 0.0252 and a p-value of 0.248. The R-squared value of 0.0948 indicates that approximately 9.48% of the variation in Return on Assets (ROA) can be explained by the independent variables in the model. This value is relatively low, indicating that the model's ability to explain ROA variation is limited. However, the F-statistic value of 0.0015 with a very small p-value indicates that, simultaneously, the independent variables in the model have a significant effect on ROA. This means that although the model as a whole is statistically significant, its ability to explain ROA variability is still limited.

The regression results for Indonesian companies show that the ESG variable coefficient is negative and significant at the 5% level ( $p = 0.034$ ). This indicates that an increase in ESG scores is associated with a decrease in ROA. The leverage variable has a significant negative effect on ROA at the 1% level.

Profit management also shows a significant negative effect on ROA at the 5% significance level. The company size variable does not show a significant effect on ROA. The R-squared value of 0.2113 indicates that approximately 21.13% of the variation in ROA can be explained by the independent variables in this model. This highly significant F-statistic value indicates that, overall, the regression model has strong statistical significance. This means that the independent variables collectively have a significant effect on ROA in Indonesian companies.

The regression results for Malaysian companies show that the ESG variable has a negative coefficient but is not statistically significant. This indicates that an increase in ESG scores does not have a significant impact on ROA in Malaysian companies. The leverage and company size variables also do not show a significant effect on ROA. Interestingly, the profit management variable shows a positive coefficient of 0.0271 and is significant at the 1% level ( $p = 0.010$ ). This indicates that profit management practices are positively associated with an increase in ROA in Malaysian companies. The R-squared value of 0.0538 indicates that approximately 5.38% of the variation in ROA can be explained by the independent variables in this model. The F-statistic value is significant, but the low R-squared value indicates that the model only explains a small portion of the variation in ROA. This may be due to other factors influencing ROA in Malaysian companies that were not included in the model.

## **Discussion**

The results of this study indicate that Environmental, Social, and Governance (ESG) scores have a negative and significant impact on the profitability of Islamic stocks in Indonesia and Malaysia. Leverage and earning management were also found to have a negative and significant impact on profitability. Interestingly, this relationship pattern remained consistent when the analysis was conducted specifically on Islamic stocks in Indonesia alone. The consistency between the combined results and the Indonesian results strengthens the evidence that the negative impact of ESG, leverage, and earning management on profitability is a stable phenomenon among Islamic companies in this region.

These findings contradict the results of a global meta-analysis by Friede, Busch, and Bassen (2015), which showed that ESG disclosure is generally positively related to financial performance. However, in the context of emerging markets, particularly companies subject to sharia principles, ESG implementation appears to be less than optimal in creating financial value. In line with the findings of Raimo et al. (2021), ESG disclosure in emerging markets is often more symbolic to meet external pressures rather than a substantial integration into corporate strategy. In the context of Islamic companies, this challenge becomes more complex as companies must balance compliance with Islamic principles and sustainability demands, which can increase compliance burdens and reduce operational flexibility.

The negative impact of leverage on profitability also reflects the limitations of financing structures in Islamic companies that avoid interest-based instruments. Profit-sharing financing models, although consistent with Islamic principles, can increase the complexity of risk management and transaction costs (Farooq & El Ghouli, 2019), ultimately squeezing profit margins. Additionally, findings that earning management negatively impacts profitability underscore the importance of integrity in Islamic companies' financial reporting. Earning management practices contradict the principles of justice and

transparency in Islam (Baydoun & Willett, 2000) and can reduce the quality of information provided to investors, thereby negatively impacting financial performance.

Overall, the consistency of findings in both the combined sample and the Indonesian sample alone confirms that the success of Islamic stock companies in maintaining profitability is not sufficient by merely complying with formal Sharia principles or adopting symbolic ESG practices. Authentic integration of sustainability values, efficient financial management, and high accountability in reporting practices are necessary to achieve sustainable financial performance. These findings can be explained within the framework of agency theory. According to Jensen and Meckling (1976), an agency relationship arises when managers' interests are not fully aligned with those of shareholders, potentially leading to agency conflicts and agency costs. In the context of this study, the negative influence of ESG on profitability may reflect the use of company resources for reputational or personal purposes of managers, which does not directly increase the value of the company in the short term. This is in line with the argument that ESG disclosure in emerging markets, including in Islamic companies, is still more symbolic than substantive (Raimo et al., 2021).

The negative impact of leverage on profitability also supports the predictions of agency theory. A capital structure that relies heavily on debt financing, even within sharia constraints, can exacerbate conflicts between owners and creditors and tighten financial constraints that limit the company's operational flexibility (Harris & Raviv, 1991). In the case of Islamic companies, reliance on complex profit-sharing financing (*mudharabah* and *musyarakah*) increases the risk of financial mismanagement, thereby suppressing profitability.

Furthermore, the negative impact of earnings management on profitability reinforces agency theory expectations that managers may manipulate financial statements to pursue personal interests, such as maintaining their position or achieving short-term performance targets, even though such actions ultimately reduce the firm's real value (Healy & Wahlen, 1999). In Islamic companies, these practices become more problematic, as they not only violate classical agency principles but also contradict the principles of transparency and fairness that form the core of Islamic accounting (Baydoun & Willett, 2000).

Thus, the findings of this study provide empirical evidence supporting agency theory in the context of Islamic stock companies. Agency conflicts reflected in ineffective ESG disclosure practices, suboptimal leverage usage, and accounting manipulation contribute to reduced profitability. Therefore, improving oversight mechanisms and strengthening internal governance, particularly those based on Islamic principles, are crucial to minimizing conflicts of interest and enhancing the sustainable financial performance of Islamic companies.

This study found that in Malaysian Islamic companies, earnings management has a positive and significant effect on profitability, while ESG disclosure, leverage, and size are also significant variables. These findings indicate that in the context of Islamic companies, the quality of financial statement management plays a more important role in financial performance than sustainability factors or other factors such as leverage.

The positive effect of earnings management on profitability can be explained through the agency theory concept. In situations where supervisory mechanisms are not yet optimal, managers have an incentive to adjust financial statements to make financial performance look better (Healy and Wahlen, 1999). The practice of earnings management by increasing profits in the short term has the potential to increase agency conflicts between managers and shareholders (Jensen & Meckling, 1976). In Islamic companies, this is even more important because transparency and fairness are fundamental principles

in Islamic financial reporting (Baydoun & Willett, 2000). On the other hand, the absence of a significant influence of ESG on profitability can be explained through signaling theory. ESG score disclosure has not been able to provide effective signals to investors to increase their trust in the company. These results reinforce the findings of Raimo et al. (2021), which indicate that ESG practices in developing countries tend to be reactive and formalistic.

ESG disclosure in Islamic companies should be understood not only as sustainability reporting but also as part of a commitment to Islamic ethical principles. The concept of Islamic ethical disclosure emphasizes the values of justice, transparency, social responsibility, and concern for the welfare of society. If ESG disclosure does not contribute to profitability, this may indicate that the disclosure made does not fully reflect the ethical principles expected of Islamic companies. In line with the views of Haniffa and Hudaib (2007), success in building sharia-based values does not only depend on formal compliance, but also on the extent to which ethical values are internalized in the company's operational practices and communications.

The Islamic company perspective requires ESG disclosure to be understood not only as a form of global sustainability reporting but also as a manifestation of commitment to Islamic ethical principles. Islamic ethical disclosure emphasizes the values of justice, transparency, social responsibility, and concern for the welfare of society. The failure of ESG disclosure to contribute to profitability may indicate that the disclosure made does not fully reflect the ethical principles expected of Islamic companies. In line with the views of Haniffa and Hudaib (2007), success in creating sharia-based value does not only depend on formal compliance, but also on the internalization of ethical values in the company's operational practices and communication.

The research findings in Malaysia contradict the results of Lee & Isa (2020 and 2022). Lee & Isa (2020) found that ESG disclosure scores can improve the performance of Islamic companies in Malaysia. These findings contradict agency theory, which views ESG disclosure as potentially increasing agency conflicts between managers and shareholders, but support stakeholder theory. The findings of Lee & Isa (2022) reinforce the study by Lee & Isa (2020), namely that Islamic companies perform better than non-Islamic companies and that ESG disclosure has an impact on achieving superior performance and increasing company value. Lee and Isa (2022) state that Islamic companies.

## **Conclusions**

This study examines the impact of ESG score disclosure on profitability in Islamic companies listed on the Indonesia Stock Exchange and the Malaysia Stock Exchange during the period 2015-2023, with control variables including leverage, earnings management, and firm size. The study employs panel data regression with a robust standard error FEM model. The sample consists of Islamic companies with ESG scores and financial statements available for the study period, resulting in 492 observations. ESG disclosure is measured using ESG scores obtained from Eikon Refinitive, while financial data is sourced from Eikon Refinitive and annual financial statements accessed via company websites.

The results indicate that, overall, ESG disclosure has a significant negative impact on the profitability of Islamic stock companies in Indonesia and Malaysia. This finding is consistent with previous studies on Islamic stock companies in Indonesia, where ESG disclosure also showed a significant negative impact on profitability. These results suggest that, in the context of Islamic companies, ESG disclosure during the study period has not yet been able to contribute positively to corporate financial performance. This reinforces the view that ESG implementation in Islamic

companies still faces challenges in integrating sustainability principles into business strategies that have a real impact on financial value creation. The results of this study are in line with agency theory, which states that ESG disclosure will trigger the emergence of agency conflicts.

Unlike the results in Indonesia, the analysis of Islamic stock companies in Malaysia shows that ESG disclosure does not have a significant effect on profitability. Conversely, earning management, as one of the control variables, was found to have a positive and significant effect on profitability. These results reflect that, in the Malaysian context, the quality of financial reporting and profit management strategies play a more dominant role in influencing the financial performance of Islamic companies than ESG disclosure practices. These findings indicate that in the Malaysian market, ESG disclosure may not yet be accepted by the market as a strong enough signal to influence perceptions of company value.

This study has several limitations. It only tested the overall influence of ESG scores without considering the influence of each ESG pillar, namely the environmental, social, and governance pillars, and did not group companies into high and low ESG scores. Additionally, this study did not consider the influence of industry type, did not include sharia compliance as a variable, and did not use moderating or mediating variables. Future research on this topic, to obtain better and more comprehensive results, could consider the limitations of this study, such as using moderating variables and mediating variables that also influence profitability.

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