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The effect of environmental, social, and governance practices on profitability performance with financial slack as a moderator

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Abstract

This study aims to obtain empirical evidence on the effects of environmental, social, and governance (ESG) on the profitability performance of Islamic companies, incorporating the moderating effect of financial slack in this relationship. The sample includes Islamic companies listed on the Jakarta Islamic Index 70 (JII 70) and the SRI KEHATI index over the 2021-2023 period, resulting in 129 firm-year observations. Panel data analysis using Eviews 13 software identified the Random Effect Model as the best approach. Findings indicate that ESG practices significantly affect profitability, supporting agency theory by suggesting that management may engage in ESG activities that incur costs without clear financial benefits for shareholders. Financial slack does not moderate the ESG-profitability relationship. Instead, financial slack, proxied by the cash ratio, directly impacts profitability. These findings suggest that while ESG practices may have profitability trade-offs, financial flexibility could enhance profit potential in Islamic companies. For policymakers, these results underscore the need to tailor ESG frameworks to the unique financial dynamics of Islamic companies, potentially aiding these firms in achieving both sustainable and profitable growth.

Keywords: profitability, environmental, social, governance, slack

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Introduction

This study seeks to obtain initial empirical evidence on the effects of environmental, social, and governance (ESG) practices on profitability performance in companies that comply with Sharia principles. This study is based on literature stating that companies that are aware of managing environmental, social, and governance aspects in their business practices will produce sustainable company performance (Odell & Ali, 2016) and specifically, companies with high ESG scores have better company performance when the economy is good (Cho, 2023). In today's business practices, ESG practices have been integrated into the company's business practices, because they are expected to have a positive impact on increasing the level of trust of potential investors who will invest in companies with good ESG values (Cho, 2023). Furthermore, these ESG practices are also associated with sustainability initiatives because these practices will have a long-term impact on the company even though they can reduce the company's short-term income. This sustainability initiative is a commitment to maximize economic benefits for shareholders and, simultaneously, protect the interests of all stakeholders in the ESG dimension.

The involvement of companies in ESG practices is fundamentally rooted in the stakeholder theory proposed by Freeman (1994), which posits that a company's responsibilities extend beyond merely serving its stakeholders to include all stakeholders. This theory is particularly relevant in explaining how contemporary ESG practices that have been encouraged by numerous companies aim to protect environmental interests, enhance social welfare, strengthen community relations, and uphold good governance. By adopting these practices, companies can maximize their value and overall performance. Research indicates that high ESG performance can garner support from stakeholders, facilitating synergies and improved financial outcomes, especially following mergers and acquisitions (Cho et al., 2021; Sihombing & Gandakusuma, 2023). This effect is further amplified when the acquiring company exhibits strong governance practices (Cho et al., 2021). Companies that prioritize good management and value maximization recognize the importance of stakeholder value in addition to shareholder value (Deng et al., 2013; Edmans, 2011)and 2.1% above industry benchmarks. The results are robust to controls for firm characteristics, different weighting methodologies, and the removal of outliers. The Best Companies also exhibited significantly more positive earnings surprises and announcement returns. These findings have three main implications. First, consistent with human capital-centered theories of the firm, employee satisfaction is positively correlated with shareholder returns and need not represent managerial slack. Second, the stock market does not fully value intangibles, even when independently verified by a highly public survey on large firms. Third, certain socially responsible investing (SRI. Consequently, engagement in ESG activities can lead to enhanced financial performance.

Agency theory also provides an important perspective in understanding the impact of ESG practices on corporate performance (Gao et al., 2023; Habib & Mourad, 2024). According to agency theory, conflicts of interest may arise between shareholders (principals) and management (agents) due to differing objectives (Yavuz et al., 2024; Helfaya et al., 2023). Managers, as agents, may make decisions that benefit themselves rather than the shareholders (Habib & Mourad, 2024; Zheng & Feng, 2024)social, and corporate governance. However, the adoption of strong governance practices within ESG frameworks can help align management's interests with those of stakeholders and shareholders (Yavuz et al., 2024; Gao et al., 2023). By prioritizing transparency, accountability, and ethical decision-making, companies can reduce agency costs and build greater trust among stakeholders (Habib & Mourad, 2024; Helfaya et al., 2023). When companies effectively integrate ESG principles, they promote a governance structure that mitigates potential agency conflicts, ultimately enhancing corporate performance and contributing to long-term value creation for all stakeholders (Gao et al., 2023; Zheng & Feng, 2024)social, and corporate governance.

There are two studies examining the performance of Islamic companies as an impact of ESG practices (Erragragui & Revelli, 2016; Peng & Isa, 2020). Both studies found that there was no negative impact of ESG implementation on portfolio returns on Islamic stocks during the period 2007-2011. Existing literature on ESG has traditionally focused on the relationship between ESG scores and portfolio returns (Erragragui & Revelli, 2016), exploring how sustainable investing impacts investor returns. However, there remains limited research on how ESG practices specifically influence profitability metrics within firms, particularly in Islamic finance contexts like the Jakarta Islamic Index (JII70). This shift in focus addresses a critical knowledge gap in ESG impact studies by evaluating internal profitability outcomes rather than broader market returns.

Our study differs from Peng and Isa (2020), who analyzed global Islamic firms on the MSCI World Islamic Index, while this research focuses on Islamic companies on the Jakarta Islamic Index 70 (JII70). The JII70 exclusively covers Indonesian firms complying with local Sharia regulations, thus aligning with national economic goals and stricter local standards (Hersugondo et al., 2022; Mutoharoh & Najihah, 2022). By contrast, the MSCI index includes global firms, adhering to internationally recognized Sharia principles, which may allow for broader, more flexible interpretations of Islamic finance across various regions.

Method

The quantitative method used in this study leverages financial slack as a moderating variable to assess the indirect impact of ESG practices on profitability, adding depth to the analysis. Previous research indicates that factors like financial slack, liquidity, and leverage can shape the effectiveness of ESG practices on financial performance, as

companies with greater financial flexibility may better absorb or capitalize on ESG costs (Peng & Isa, 2020). By including financial slack, this study aligns with recommendations to examine contextual factors that may modify the ESG-profitability relationship, providing a more comprehensive explanatory model. This study aims to empirically test the influence of ESG practices on profitability performance through financial slack as a moderating variable. The conceptual framework in this study is shown in Figure 1.

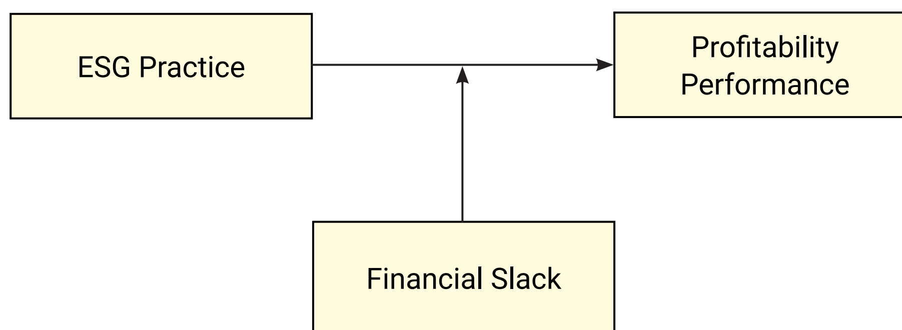

Figure 1. Theoretical Framework

Hypothesis Development

The relationship between ESG practices and profitability is rooted in stakeholder theory and agency theory (Daugaard & Ding, 2022; Gherghina, 2024). Stakeholder theory posits that companies adopting ESG practices can build stronger relationships with customers, employees, and investors, creating goodwill that may translate into financial gains (Awa et al., 2024; Buniamin, 2020). Studies support this, showing that ESG can improve firm profitability by fostering operational efficiencies and reducing risks (Suprabha et al., 2024; Tamasiga et al., 2024)businesses are increasingly gaining recognition for their non-financial performance due to heightened stakeholder demands about ethical and environmental responsibilities. This noteworthy shift in perspective has catalyzed the inception of this research, which seeks to scrutinize the influence of environmental, social, and governance disclosure (ESGD. Agency theory, however, suggests that ESG can negatively impact profitability if management uses ESG initiatives to satisfy their personal values rather than shareholder interests (Helfaya et al., 2023; Yuen et al., 2022). By testing this hypothesis, this study aims to clarify whether ESG serves as a value-enhancing practice or a cost burden for companies, especially in the context of Islamic firms on the JII70.

Financial slack, which represents a firm's buffer of excess resources, can play a moderating role in the ESG-profitability relationship (Leyva-de la Hiz et al., 2019; Singh et al., 2023)social and governance (ESG. Resource-based theory suggests that firms with greater slack can afford to invest in ESG initiatives without compromising core operations, allowing them to pursue long-term value creation (Bhandari et al., 2022; Di

Simone et al., 2022)society, and governance (ESG. Prior studies suggest that financial slack may strengthen the positive effects of ESG by providing firms the flexibility to manage associated costs and uncertainties (Daugaard & Ding, 2022; Heubeck & Ahrens, 2024; Peng & Isa, 2020). Thus, this study examines if financial slack enables firms to better leverage ESG investments for profitability, addressing gaps identified in earlier research on the conditional factors affecting ESG outcomes.

Based on the description, the research hypothesis statement that is to be tested in this study is:

H1: ESG practices have a significant effect on profitability performance

H2: Financial slack moderates the relationship between ESG practices and profitability performance

Variables

The dependent variable in this study is profitability performance proxied by return on assets (ROA). The independent variable used is environmental, social, and governance (ESG) practices. The moderating variable used is financial slack, proxied by the cash ratio and current ratio.

This study uses a return on assets (ROA) proxy to measure corporate performance because this proxy is the most commonly used measure in the literature (Li et al., 2017; Qi et al., 2014). ESG scores include the following categories: (1) Environmental, which relates to resource use, emissions, and innovation; (2) Social, which concerns labor relations, human rights, society, and product responsibility; (3) Governance, which focuses on issues related to management, shareholders, and CSR strategies. This variable refers to the ESG assessment of the SRI KEHATI index and is a dummy variable. A score of 2 for JII70 companies included in the SRI KEHATI index and a score of 1 for JII70 companies not included in the SRI KEHATI index.

Financial slack provides an opportunity for companies to invest in activities related to the environment, social, and governance. A company's financial slack exists at various levels (Mattingly & Olsen, 2018; Onuoha & Nkwor, 2021)investment in corporate social responsibility (CSR. This variable is measured by several financial ratios that refer to previous studies (Ferrell et al., 2016; Mattingly & Olsen, 2018; Onuoha & Nkwor, 2021; Tan et al., 2017; Zhang et al., 2018)investment in corporate social responsibility (CSR, namely: (1) cash ratio, measured by cash and equivalents divided by total assets; and (2) current ratio, measured by current assets divided by short-term liabilities.

Population and Sample

The research population consists of all companies listed on the Jakarta Islamic Index 70 (JII 70) during the 2021-2023 period, totaling 210 firm-year observations (70 companies across three years). Islamic financial institutions, such as banks and insurance

firms, are excluded from this study to focus solely on non-financial sectors. The sampling method used is balanced sampling, selecting only companies that remained on the JII 70 throughout the research period.

This study begins in 2021, marking the availability of detailed constituent data for JII 70. Based on screening, the final sample includes 43 non-financial companies that also appear on the SRI KEHATI index during the study period, resulting in 129 firm-year observations. This consistent sampling approach strengthens the validity of examining the effects of ESG practices on profitability.

Data Analysis

The current research data is included as panel data for a period of 3 years (2021-2023). The data is then processed using a panel data processing statistical tool with Eviews 13 software. In the regression model estimation method using panel data, three approaches can be used, including the Common Effect Model (CEM), Fixed Effect Model (FEM), or Random Effect Model (REM). Of the three regression models that can be used to estimate panel data, the regression model with the best results will be used in analyzing and testing the hypothesis. In this study, in order to find out the best model, testing was carried out using the Chow test and the Hausman test.

Result and Discussion

The Chow test is conducted to select the best model between the Common Effect Model (CEM) or the Fixed Effect Model (FEM). Decision-making by looking at the probability value (p) for cross-section F. If the p-value> 0.05, then the selected model is the Common Effect Model (CEM). However, if the p-value < 0.05, then the selected model is the Fixed Effect Model (FEM). The results of the Chow test (Table 1) show that the probability value is 0.000 (p<0.05), so it rejects the null hypothesis, or in other words, it is concluded that the better model is the Fixed Effect Model (FEM).

Table 1. Chow test

Effects Test	Statistic	d.f.	Prob.
Cross-section F	7.548391	(42,80)	0.0000
Cross-section Chi-square	205.054892	42	0.0000

The Hausman test is conducted to compare or choose the best model between FEM and Random Effect Model (REM). Decision making by looking at the probability value (p) for Cross-Section Random. If the p-value> 0.05, then the selected model is REM, while if p < 0.05, then the selected model is FEM. The results of the Hausman test (Table 2) show a probability value of 0.1764 (p>0.05), so it is concluded that the best model is the Random Effect Model (REM).

Table 2. Hausman test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	7.654129	5	0.1764

Hypothesis testing

The results of the first hypothesis test (Table 3) show a probability value of 0.0212 ($p<0.05$) with a coefficient value of -0.030593. Thus, the results of the study indicate that ESG has a significant effect on profitability performance as measured by return on assets (ROA). A negative coefficient indicates that companies that are actively engaged in ESG activities have lower profitability performance compared to companies that are not very active in ESG practices.

Table 3. First Hypothesis Testing Results

Variables	Coefficient	Std. Error	t-Statistic	Prob.
ESG	-0.030593	0.013111	-2.333379	0.0212
C	0.137658	0.023056	5.970595	0.0000

The results of the second hypothesis test (Table 4) show the probability value of the cash ratio as a moderator variable of 0.4743 ($p>0.05$) and the probability value of the current ratio as a moderator variable of 0.9661 ($p>0.05$). Thus, the results of the study indicate that financial slack, as proxied by the cash ratio and current ratio, is not able to moderate the relationship between ESG practices and profitability performance. However, the probability value of financial slack as proxied by the cash ratio is 0.0053 ($p<0.05$), so it is concluded that financial slack is a predictor that directly affects profitability performance. Meanwhile, financial slack, as proxied by the current ratio, has a probability value of 0.6660 ($p>0.05$), indicating that the current ratio is not a predictor that directly affects profitability performance.

Table 4. Second Hypothesis Testing Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
ESG	-0.002189	0.021290	-0.102797	0.9183
Cash Ratio	0.407156	0.143318	2.840934	0.0053
Current Ratio	0.001667	0.003853	0.432718	0.6660
ESG*Cash Ratio	-0.073384	0.102249	-0.717696	0.4743
ESG*Current Ratio	-0.000107	0.002520	-0.042564	0.9661
C	0.040089	0.034750	1.153652	0.2509

The Effect of ESG Practices on Profitability Performance

The findings indicate that ESG practices have a negative and significant effect on profitability, aligning with agency theory rather than stakeholder theory (Gherghina, 2024; Suprabha et al., 2024). Instead of benefiting shareholders, ESG practices can lead to agency conflicts, as managers (agents) might prioritize ESG investments that do not directly enhance shareholder value (Daugaard & Ding, 2022; Helfaya et al., 2023). Such practices often result in cash outflows that reduce profits, thereby creating tension between shareholders (principals) and managers (Tamasiga et al., 2024; Yuen et al., 2022). This conflict arises because while ESG initiatives fulfill non-financial objectives, they may compromise immediate profitability, contrary to shareholder interests for financial gains (Buniamin, 2020; Suprabha et al., 2024). From here, a conflict arises between shareholders as principals and managers as agents (Jensen & Meckling, 2012).

The results of this study indicate that there is opportunistic behavior from managers in order to fulfill their personal interests (Brown et al., 2006) through ESG practices, and managers are personally motivated to build their image without regard to the rights of shareholders or principals (Barnea & Rubin, 2010). The results of the study are also in line with the results of other studies which show that projects that are more profitable for the company cannot be implemented or are displaced by the company's involvement in ESG activities (Schuler & Cording, 2006), so that the company's position becomes less profitable when compared to the position of other companies that are not actively seen in activities related to the environment, social, and governance (Allouche & Laroche, 2005). The results of the study also show that there is a negative impact from the company's involvement in ESG activities because it triggers managers to carry out practices termed window dressing to cover up poor company performance by involving themselves in activities related to ESG.

The results of this study have found that ESG practices carried out by companies listed on JII70 and SRI KEHATI have a negative effect on profitability performance. The results of the study are in line with previous empirical studies (Allouche & Laroche, 2005; Barnea & Rubin, 2010; Borghesi et al., 2014; Brown et al., 2006; Kao et al., 2018; Schuler & Cording, 2006). The results of this study empirically prove that the negative impacts on company performance, including ESG practices carried out by companies are actually a manifestation of agency problems (Benabou & Tirole, 2010; Masulis & Reza, 2015), more accommodating to managers' interests in obtaining personal gain compared to shareholder interests (Brown et al., 2006; Krüger, 2015), expenses related to ESG practices only improve the image and reputation of managers personally (Barnea & Rubin, 2010), focusing more on the ESG practices they carry out makes managers ignore core tasks related to their managerial duties (Jensen, 2010)however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch

over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are easily apt to consider attention to small matters as not for their master's honour and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. Adam Smith, The Wealth of Nations, 1776, Cannan Edition (Modern Library, New York, 1937, and ultimately ESG practices are related to a decrease in company value (Nguyen et al., 2023). Thus, the sample studied shows that ESG practices have a negative impact on profitability performance.

The Moderating Effect of Financial Slack on the Relationship between ESG Practices and Profitability Performance

The study results found that financial slack cannot moderate the relationship between ESG practices and profitability performance. Financial slack proxied by cash, bank cash and other cash equivalents that can be easily used (Kraatz & Zajac, 2001), based on the results of this study cannot moderate the relationship between ESG practices and performance. The results of the current study are not in line with the concept that companies with high levels of financial slack can allocate some of their funds and integrate activities related to the environment and society into their business strategies and objectives (Campbell, 2007). The results of this study are not in line with several empirical studies (Qi et al., 2014; Tan et al., 2017) which found a positive moderating effect of slack resources on the relationship between environmental performance and financial performance in the travel and tourism industry. Thus, it can be concluded from the results of this study that financial slack, as well as liquidity and leverage, cannot moderate the impact of corporate involvement in ESG activities on the profitability performance of sharia companies listed on JII 70.

Conclusion

The current study aims to obtain empirical evidence regarding the effect of ESG on the performance of sharia companies listed on JII70 and also listed on the SRI KEHATI ESG index in the 2021-2023 period. This study also examines the moderating effect of financial slack on the relationship between ESG practices and company performance. The study findings indicate that ESG practices implemented by companies have a negative impact on company performance. ESG practices in the sample of companies listed on JII 70 are still considered costs that are detrimental to the company because they reduce the profits obtained by the company. The results of this study do not support the stakeholder theory argument but instead confirm the argument from agency theory, which states that ESG practices have a negative effect on company performance. The findings of other

studies indicate that financial slack cannot moderate the effect of ESG practices on company performance. On the contrary, the results of the study found that financial slack is a predictor that directly affects profitability performance.

For sharia-compliant companies, the findings highlight the need to carefully assess ESG investments, potentially focusing on cost-effective ESG strategies that align more closely with profit goals. Actionable recommendations include implementing governance practices that minimize agency costs associated with ESG activities, thus balancing social responsibility with financial performance.

This study contributes to agency theory and stakeholder theory by showing that, in the context of sharia-compliant companies, ESG practices may create agency costs, supporting agency theory rather than stakeholder theory. Instead of increasing firm profitability, ESG activities often result in expenses that may not yield direct financial gains, highlighting conflicts between managers' ESG actions and shareholder interests. Furthermore, the findings challenge stakeholder theory's idea that ESG naturally boosts profitability, suggesting that Islamic firms may need to adapt ESG strategies to balance financial and social objectives.

Further research can use other moderating variables such as liquidity and financial constraints, in moderating the relationship between ESG and profitability. In addition, the ESG index can be substituted with other ESG indices that better reflect environmental, social, and governance activities in accordance with Sharia principles and, if necessary, better reflect the Sharia industry specifically, such as Islamic banks, Sharia insurance, and other Islamic financial institutions. Further research can also extend the research period to obtain better study results, especially on the ability of several variables to moderate the relationship between ESG practices and company performance.

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