

## DETERMINANT ESG PERFORMANCE : THE IMPACT OF SHARIA STATUS, FIRM CHARACTERISTICS AND OWNERSHIP STRUCTURE

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### ABSTRACT

This study aims to analyze the factors influencing Environmental, Social, and Governance (ESG) performance among companies listed on the Indonesia Stock Exchange. The sample consists of 447 firm year observations covering the period from 2021 to 2024. The independent variables examined include Sharia status, firm characteristics namely profitability, leverage, and firm size, as well as ownership structure represented by institutional ownership and foreign ownership. The analysis is conducted using multiple linear regression. The results indicate that Sharia status has a positive and significant effect on ESG performance, suggesting that firms complying with Sharia principles tend to demonstrate better ESG practices than non-Sharia firms. In addition, profitability, and firm size are also found to have positive and significant effects on ESG performance. In contrast, debt to equity, institutional ownership and foreign ownership do not show a significant relationship with ESG performance. These findings highlight that firms' financial characteristics and adherence to Sharia principles play an important role in enhancing ESG performance. Meanwhile, ownership structure does not appear to be a primary determinant in explaining variations in ESG performance among the sampled firms. This study contributes to the growing literature on ESG determinants in emerging markets and provides practical implications for investors and regulators in promoting sustainable business practices in the Indonesian capital market.

Keywords : ESG Performance; Sharia-Compliant Stocks; Profitability; Leverage; Firm Size; Ownership Structure

### ABSTRAK

Penelitian ini bertujuan untuk menganalisis faktor-faktor yang memengaruhi kinerja Environmental, Social, and Governance (ESG) pada perusahaan yang tercatat di Indonesia Stock Exchange. Sampel penelitian terdiri dari 447 observasi perusahaan-tahun selama periode 2021–2024. Variabel independen yang diuji meliputi status syariah, karakteristik perusahaan meliputi profitabilitas, leverage, ukuran perusahaan, dan struktur kepemilikan meliputi kepemilikan institusional dan kepemilikan asing. Analisis dilakukan menggunakan regresi linear berganda. Hasil analisis menunjukkan bahwa status syariah berpengaruh positif dan signifikan terhadap kinerja ESG. Temuan ini mengindikasikan bahwa perusahaan yang memenuhi kriteria syariah cenderung memiliki praktik ESG yang lebih baik dibandingkan perusahaan non-syariah. Selain itu, profitabilitas, dan ukuran perusahaan juga terbukti memberikan pengaruh positif dan signifikan terhadap kinerja ESG. Sebaliknya, leverage, kepemilikan institusional dan kepemilikan asing tidak menunjukkan hubungan yang signifikan dengan kinerja ESG perusahaan. Temuan ini menegaskan bahwa karakteristik keuangan perusahaan serta kepatuhan terhadap prinsip syariah merupakan faktor penting dalam mendorong peningkatan kinerja ESG. Sementara itu, struktur kepemilikan tidak menjadi determinan utama dalam menjelaskan variasi kinerja ESG pada perusahaan yang diteliti. Penelitian ini memberikan kontribusi pada pengembangan literatur mengenai determinan ESG di pasar negara berkembang serta memberikan implikasi praktis bagi investor dan regulator dalam mendorong penerapan praktik bisnis berkelanjutan di pasar modal Indonesia.

Kata Kunci : ESG Performance; Saham Syariah; Profitabilitas; Leverage; Ukuran Perusahaan; Struktur Kepemilikan

## INTRODUCTION

Environmental, Social, and Governance (ESG) has evolved into a critical framework for evaluating corporate sustainability, shifting the focus from short-term performance toward long-term value creation. Existing studies indicate that ESG integration enhances financial performance, reduces risk, and strengthens corporate reputation, thereby supporting sustainable shareholder value (Zumente & Bistrova, 2021). Furthermore, firms with strong ESG practices demonstrate superior risk-adjusted performance and greater resilience, particularly during periods of market uncertainty (Minev & Dankova, 2025). The importance of ESG is even more pronounced in emerging markets, where it serves as a strategic mechanism to address governance challenges, attract investment, and improve competitiveness. Empirical evidence also confirms that higher ESG performance is positively associated with firm valuation, reflecting investors' preference for more transparent and resilient firms in such environments (Rahat & Nguyen, 2024). In addition, ESG performance is associated with improved credit ratings, indicating its role as a signal of lower risk and stronger corporate governance (Oktavianti & Gunawan, 2025).

In Islamic finance, firms classified as sharia-compliant firms are generally associated with a stronger commitment to ethical principles, particularly in social and environmental dimensions. Grounded in the principles of *Maqasid al-Sharia*, sharia-compliant firms are expected to balance economic objectives with social justice, environmental stewardship, and public welfare. Prior studies suggest that sharia-compliant firms tend to demonstrate superior environmental and social performance compared to non-Sharia firms, which has been attributed to leverage restrictions, healthier asset structures, and prohibitions against non-halal income (Qoyum et al., 2022; Tariq et al., 2025). However, such advantages are not consistently reflected in governance performance, as Sharia screening processes primarily emphasize financial ratios and business activity criteria without explicitly incorporating governance indicators.

Previous empirical investigations into the Islamic label and ESG performance reveal divergent outcomes depending on the context. Several studies in Indonesia suggest that Sharia status does not automatically improve the quality of ESG disclosure, especially in industries with high environmental impact such as mining and energy. In these industries, environmental obligations, including Asset Retirement Obligations (ARO), are frequently perceived as regulatory compliance costs rather than as reflections of Islamic sustainability principles. As a result, the Islamic label may function primarily as a reputational signal, especially for large firms subject to greater stakeholder scrutiny, rather than as a substantive driver of environmental commitment (Salisa et al., 2025). Furthermore, evidence from the energy sector suggests that the Islamic label may be associated with lower ESG performance, particularly in the

environmental dimension, thereby highlighting the limitations of Sharia screening mechanisms in fully capturing firms' sustainability outcomes (Awaludin et al., 2025).

Profitability represents another key determinant of ESG performance. Empirical findings remain inconclusive, thereby creating space for further investigation. Large cross-country studies suggest that more profitable firms tend to exhibit superior ESG performance across dimensions due to greater resource availability, organizational capacity, and reputational incentives to invest in sustainability and transparency (Carreira & Silva, 2025; Wang et al., 2025). Conversely, other studies find that profitability does not significantly affect aggregate ESG or its environmental and social dimensions, and may even negatively influence governance quality, suggesting that strong financial performance does not necessarily align with improved governance practices (Awaludin et al., 2025; Qasem et al., 2022; Zhang & Wu, 2024). These inconsistencies indicate that the relationship between profitability and ESG is contextual and potentially non-linear, influenced by institutional settings, legitimacy pressures, and governance mechanisms.

Leverage is theoretically regarded as a factor that may constrain ESG performance due to financial obligations and debt-related pressures. However, empirical evidence remains limited and inconclusive. Several studies report that leverage negatively and significantly affects aggregate ESG and environmental performance, suggesting that debt-based financing structures reduce firms' flexibility to allocate resources toward sustainability investments and environmental management (Zhang & Wu, 2024; Likitapiwat et al., 2024; Martiny et al., 2024; Awaludin et al., 2025). Nonetheless, the existing literature often treats leverage as a control variable rather than as a strategic determinant of ESG, leaving its broader implications insufficiently explored (Qoyum et al., 2020).

Firm size is widely recognized as a key determinant of ESG performance, although empirical findings suggest heterogeneity, indicating the possibility of a non-linear relationship. Most studies show that larger firms are more likely to exhibit stronger ESG performance or higher levels of disclosure due to their greater financial and organizational capacity, enhanced public exposure, and stronger pressure from stakeholders to maintain legitimacy (Awaludin et al., 2025; Martiny et al., 2024; Qoyum et al., 2020; Salisa et al., 2025; Ye & Sha, 2025; Yu, 2023; Zhang & Wu, 2024). However, the magnitude of this association differs across rating agencies and industry contexts, and in certain cases, no statistically significant relationship is observed (Gregory, 2022). Other studies document a U-shaped association between firm size and ESG, whereby small to medium-sized firms may initially exhibit relatively strong ESG performance, while larger firms face organizational constraints before improving their ESG outcomes once they reach a certain scale due to increased institutional pressures and resource

availability (Likitapiwat et al., 2024). Some studies also report non-significant effects (Mart, 2021; Qasem et al., 2022).

Institutional ownership is theoretically considered an effective external governance mechanism that can enhance ESG performance through monitoring functions, mitigation of agency problems, and voice and exit mechanisms. Nevertheless, empirical findings remain inconsistent and context-specific. Some studies report that institutional ownership positively and significantly influences ESG performance or disclosure, particularly when institutional investors are long-term oriented and actively engaged in corporate monitoring (Alazzani et al., 2017; Qasem et al., 2022; Sun & Zhao, 2024). However, evidence from emerging markets suggests that institutional ownership does not always function as an ESG driver and may even be insignificant or negative, which is attributed to short-term investment orientation, weak ESG regulation, and voluntary disclosure practices (Zairin et al., 2025). Recent research further suggests a U-shaped relationship, where institutional investors initially perceive ESG as a cost at low to moderate ownership levels, with positive effects emerging only after ownership reaches a critical mass (Mart, 2021). These inconsistencies reveal a research gap in understanding when and under what conditions institutional ownership effectively promotes ESG, particularly considering investor heterogeneity, ownership concentration, and institutional contexts in emerging markets.

Foreign ownership, including Qualified Foreign Institutional Investors (QFII), is often viewed as a strong external governance mechanism capable of enhancing ESG performance. Foreign investors are generally long-term oriented, adhere to stricter sustainability standards, and strengthen monitoring mechanisms through improved transparency, increased analyst coverage, and capital market pressure. Moreover, foreign investors may transfer global ESG practices and standards into domestic markets, thereby encouraging firms to prioritize sustainable value creation over short-term profitability (Wang et al., 2025).

While several studies find that foreign ownership positively influences ESG performance, through reducing managerial short-termism, enhancing transparency, strengthening legitimacy pressures, and attracting analyst and media attention (Abdelkader, 2023; Yu, 2023; Zhang & Wu, 2024), empirical evidence remains inconclusive. Some studies suggest that foreign ownership does not necessarily lead to higher ESG scores or increased investment; instead, it tends to mitigate excessive ESG investment and improve ESG efficiency only under specific conditions, and becomes insignificant in firms characterized by high levels of information asymmetry (Kim, 2025). These inconsistencies indicate a research gap concerning the conditions under which foreign ownership can effectively enhance ESG

performance, particularly in relation to information transparency and institutional environments in emerging markets.

Building on these gaps, this study aims to investigate the impact of Sharia status and ownership structure on corporate ESG performance, while incorporating firm-specific characteristics within the Indonesian capital market context. This study is expected to make a theoretical contribution by advancing the existing body of knowledge on ESG, Islamic finance, firm characteristics, and ownership structure. From a practical perspective, it offers valuable insights for regulators and investors in formulating policies and investment strategies that align Sharia principles with global sustainability objectives.

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

### Shariah Enterprise Theory

Shariah Enterprise Theory (SET) provides a conceptual framework that critiques the conventional firm paradigm centered on profit maximization by positioning the firm as a moral and spiritual entity. Grounded in Islamic principles, SET views humans as trustees (*amanah*) of resources ultimately owned by Allah, implying that business activities must be conducted based on justice and responsibility toward all stakeholders, including society and the natural environment (Widiyanti et al., 2025). SET emphasizes dual accountability: vertical accountability to Allah as the ultimate owner of trust, and horizontal accountability to human beings and nature. Within this framework, social and environmental responsibility is understood as an inherent ethical obligation of the firm. Corporate social responsibility is therefore not considered a voluntary activity but an integral component of Islamic teachings aimed at achieving *maslahah* (public interest) and long-term sustainability.

In the context of reporting and sustainability, Makatita et al. (2024) argue that SET provides a more holistic normative foundation compared to conventional firm theories. CSR disclosure and sustainability reporting are not framed as voluntary initiatives or mere legitimacy tools, but as moral and spiritual obligations that must be carried out with honesty and integrity. By integrating economic, social, environmental, and spiritual dimensions, SET transcends the limitations of conventional approaches and offers a model of accountability aligned with *maslahah* and sustainable development objectives.

Furthermore, Kusmiati & Ungkari (2021) utilize SET as a theoretical framework to examine the social responsibility of sharia-compliant firms from a broader accountability perspective. Within this framework, sharia-compliant firms are expected to be accountable not only to shareholders but also to a wider range of stakeholders influenced by corporate activities, including employees, communities, and the natural environment. CSR disclosure serves as an expression of corporate accountability, indicating adherence to Sharia principles and Islamic

ethical values, while also reflecting a firm's dedication to social responsibility and sustainable practices.

The concept of sustainability within SET is also closely aligned with the ESG framework. From an Islamic perspective, sustainability is not merely a business strategy or regulatory compliance mechanism, but a form of trust and worship that reflects the relationship between humans and Allah as well as among humans themselves (Widiyanti et al., 2025). Accordingly, ESG within the SET framework is understood as a moral and spiritual consequence of managing entrusted resources, rather than merely a reputational instrument. Empirical evidence by Qoyum et al., (2021) demonstrates that integrating Islamic values with ESG principles through Islamic Socially Responsible Investment portfolios yields superior and more resilient portfolio performance.

### **Legitimacy Theory**

Legitimacy Theory is grounded in the notion that organizational survival depends on the extent to which corporate activities and outputs are perceived as consistent with societal values, norms, and expectations. The concept of organizational legitimacy was systematically introduced by Dowling & Pfeffer (1975), who argue that organizations operate under an implicit social contract with society. To maintain social acceptance, firms must align their actions and communications with prevailing social values. When discrepancies arise between corporate behavior and societal expectations, a legitimacy gap may emerge, threatening organizational continuity.

The conceptual development of Legitimacy Theory was further elaborated by Suchman (1995), who classifies legitimacy into three primary dimensions. The first is pragmatic legitimacy, which arises from stakeholders perceived benefits or self interest. The second is moral legitimacy, which reflects normative judgments regarding the appropriateness of corporate actions. The third is cognitive legitimacy, which refers to the extent to which organizational activities are widely accepted and taken for granted within society. This typology enriches the understanding of legitimacy as not merely instrumental but also normative and cognitive, and as something that can be strategically managed by firms through both substantive actions and symbolic communication.

Within the accounting and social reporting literature, Deegan (2002) applies Legitimacy Theory to explain corporate motivations for social and environmental disclosure. He argues that CSR and sustainability reporting are often used as mechanisms to gain, maintain, or restore legitimacy, particularly when firms face public pressure arising from environmental or social impacts of their operations. In the ESG era, contemporary research confirms the continued relevance of Legitimacy Theory in explaining corporate sustainability practices. Recent studies

highlight that ESG performance and ESG disclosure function as legitimacy mechanisms that signal alignment with global sustainability norms, especially amid increasing pressure from investors, regulators, and civil society (Ali et al., 2020; Cho et al., 2012).

Legitimacy becomes particularly critical in emerging markets, where ESG regulatory regimes tend to be weaker, disclosure practices remain largely voluntary, and information asymmetry is relatively high. Recent evidence suggests that firms in emerging markets use ESG as a tool to bridge the legitimacy gap between domestic business practices and global expectations, particularly when firms are internationally oriented or exposed to foreign investors (Ali et al., 2020). Under such conditions, ESG serves both as a signal of normative compliance and as a mechanism for acquiring institutional legitimacy.

### **Hypothesis Development**

#### **Islamic Label and ESG Performance**

In the perspective of Islamic finance, the presence of Sharia-compliant firms reflects a normative orientation toward ethical, responsible, and sustainable business conduct. Grounded in the principles of Maqasid al-Sharia, economic activities are not solely directed toward profit maximization but also toward the protection of social interests, environmental sustainability, and public welfare (Widiyanti et al., 2025). These principles encourage sharia-compliant firms to internalize sustainability values in both operational and strategic decision-making processes.

Empirical evidence suggests that sharia-compliant firms tend to exhibit stronger ESG performance compared to their non-sharia counterparts. Qoyum et al., (2022) find that restrictions on leverage, the prohibition of non-halal income, and healthier asset structures in sharia-compliant firms contribute to more responsible environmental and social practices. Similarly, Tariq et al., (2025) demonstrate that adherence to sharia principles is positively associated with enhanced ESG performance, particularly across environmental and social aspects, due to stronger ethical and moral motivations embedded in business activities.

Furthermore, the sharia label functions as an ethical signal for investors who prioritize sustainable and responsible investment. This signaling effect encourages firms to improve the extent and transparency of ESG disclosure and practices to maintain legitimacy and investor confidence in the market. Therefore, the Islamic label not only represents compliance with religious principles but also serves as a mechanism that reinforces a firm's long-term sustainability orientation.

H<sub>1</sub>: Sharia status has a positive effect on corporate ESG performance.

#### **Profitability and ESG Performance**

Based on legitimacy theory Dowling & Pfeffer (1975), profitability is viewed as a strategic resource that enables firms to respond to stakeholder demands and maintain social

legitimacy through investments in and disclosure of sustainability practices. Firms with higher levels of profitability possess greater financial capacity, operational flexibility, and reputational incentives to implement Environmental, Social, and Governance (ESG) policies more comprehensively.

Cross-country empirical evidence consistently demonstrates that profitability has a positive effect on ESG performance. Carreira & Silva (2025), using global panel data consisting of more than 28,000 firm-year observations during the period 2019–2023, find that profitability is positively associated with the overall ESG score as well as with each dimension ESG. These findings indicate that more profitable firms tend to be more proactive in adopting and disclosing sustainability practices, as they possess stronger organizational resources and legitimacy incentives.

Consistent findings are documented by Wang et al (2025) and Awaludin et al. (2025) who demonstrate that profitability constitutes a key driver of corporate ESG performance, particularly by strengthening firms' capacity to fulfill stakeholder expectations and enhance corporate reputation. Conceptually, higher profitability provides stronger economic incentives for firms to embed ESG considerations into their long term strategic orientation, rather than perceiving them solely as compliance related activities.

H<sub>2</sub>: Profitability has a positive effect on ESG performance

### **Leverage and ESG Performance**

Leverage is expected to negatively influence ESG performance, as elevated debt levels typically impose financial constraints and reduce managerial discretion. Firms with high leverage are more likely to focus on short-term financial obligations, liquidity preservation, and adherence to debt covenants, which can restrict their capacity to invest in long-term sustainability initiatives. From this perspective, ESG-related investments are frequently perceived as discretionary expenditures that can be postponed when firms face financial constraints. Consequently, highly leveraged firms may exhibit lower commitment to environmental, social, and governance practices. This argument is supported by prior empirical studies, such as Zhang & Wu (2024) and Martiny et al (2024), which document a negative relationship between leverage and ESG performance, indicating that financial risk and debt obligations can hinder firms' sustainability engagement.

However, empirical evidence suggests that when leverage reaches high levels, financial pressure tends to dominate this disciplinary mechanism. Firms with substantial debt face constraints in financial flexibility and increasing pressure to meet interest and principal repayment obligations, which shifts managerial focus toward short-term survival. This condition reduces the financial slack required to support long-term ESG investments that do not generate

immediate cash flows, such as environmental initiatives, social responsibility programs, and employee welfare policies (Qoyum et al., 2022).

Consistent with this argument, several prior studies report that leverage has a negative effect on ESG performance. This evidence suggests that financial distress pressures and compliance with debt covenants may limit firms' capacity to implement comprehensive sustainability practices. Consequently, high levels of debt tend to weaken corporate commitment to ESG, particularly when managerial priorities are more strongly oriented toward maintaining liquidity stability and managing default risk (Zhang & Wu, 2024; Likitapiwat et al., 2024; Martiny et al., 2024; Awaludin et al., 2025).

H<sub>3</sub>: Leverage has a negative effect on corporate ESG performance

### **Firm Size and ESG Performance**

Firm size constitutes an important structural determinant in explaining variations in ESG performance. Within the framework of legitimacy theory proposed by Dowling & Pfeffer (1975), larger firms face greater public exposure, stronger stakeholder pressure, and more intensive regulatory scrutiny compared to smaller firms. These conditions encourage large firms to adopt and disclose sustainability practices more extensively as a mechanism to maintain social legitimacy and corporate reputation. Operationally, larger firms interact with a broader stakeholder base including institutional investors, regulators, the media, and the general public who demand higher levels of transparency and accountability regarding environmental and social impacts. High public visibility also increases reputational costs when firms fail to meet ESG expectations, thereby strengthening managerial incentives to integrate sustainability into long term business strategies.

In addition to external pressures, larger firms generally possess greater resource capacity in terms of financial, organizational, and technological capabilities to implement ESG policies more comprehensively. Their larger asset base and stronger financial capacity enable firms to bear the costs associated with ESG implementation, including long-term environmental investments, social responsibility programs, and the development of more sophisticated governance and sustainability reporting systems. This argument is consistent with empirical findings reported by Zhang & Wu (2024) and Wang et al. (2025) and which demonstrate that firm size has a positive and significant effect on ESG performance. These findings reflect the combined influence of legitimacy pressure and internal capabilities that enable firms to respond effectively to sustainability demands. Firm size therefore reflects not only the level of external exposure and monitoring but also the firm's capacity and incentives to meet stakeholder expectations. Consistent with prior studies (Awaludin et al., 2025; Martiny et al., 2024; Qoyum

et al., 2020; Salisa et al., 2025; Ye & Sha, 2025; Yu, 2023; Zhang & Wu, 2024), larger firms are more likely to adopt ESG practices more consistently and with higher quality.

H<sub>4</sub>: Firm size has a positive effect on ESG performance

### **Institutional Ownership and ESG Performance**

Institutional ownership is commonly recognized as a crucial external governance mechanism that encourages firms to adopt corporate sustainability practices. From an agency theory standpoint Jensen & Meckling (1976), the presence of institutional investors with substantial shareholdings enhances monitoring effectiveness over managerial actions. Such monitoring reduces opportunistic behavior and alleviates agency conflicts between managers and shareholders. This perspective is further supported by legitimacy theory Dowling & Pfeffer (1975), which suggests that firms seek to preserve legitimacy by ensuring that their actions are aligned with societal expectations. In this regard, institutional investors may motivate firms to implement ESG practices as strategic initiatives aimed at sustaining legitimacy while fostering long-term value creation.

A growing body of empirical evidence suggests that institutional ownership is positively and significantly related to ESG performance. Alazzani et al (2017) show that institutional investors play an important role in enhancing ESG outcomes through more effective monitoring and continuous oversight of corporate policies. In a similar vein, Qasem et al (2022) report that different forms of institutional ownership improve the quality of ESG disclosure by fostering greater transparency and accountability as part of non-financial risk management practices.

More recent studies highlight the role of institutional investors in fostering long-term corporate orientation through mechanisms such as shareholder voice and exit threats. Sun & Zhao (2024) report that higher levels of institutional ownership are positively linked to improved ESG performance, as institutional investors help mitigate managerial short-term orientation and facilitate the incorporation of ESG considerations into corporate strategies for risk management and long-term sustainability. Furthermore, Ye & Sha (2025) reveal that certain ownership structures, particularly common institutional ownership, enhance ESG performance by reinforcing governance oversight and providing resources that support sustainable investment. In this context, institutional investors serve not only as effective monitors but also as strategic facilitators that help firms reduce financial constraints and improve the overall quality of ESG implementation.

H<sub>5</sub>: Institutional ownership has a positive effect on corporate ESG performance

### **Foreign Ownership and ESG Performance**

Foreign ownership is widely recognized as an effective external governance mechanism that can enhance ESG performance, particularly in emerging markets. Based on the agency

theory framework introduced by Jensen & Meckling (1976) and supported by legitimacy theory as formulated by Dowling & Pfeffer (1975), foreign investors tend to promote stronger governance practices, a longer-term strategic orientation, and heightened sensitivity to reputational risks. These characteristics encourage firms to adopt sustainability practices more rigorously and to disclose ESG-related information in a more transparent manner.

Empirical studies provide evidence of the beneficial role of foreign ownership in improving ESG performance. Yu (2023) finds that the involvement of foreign shareholders mitigates managerial short-termism and enhances the quality of corporate disclosure. Moreover, foreign investors tend to demand higher ESG standards as an integral component of risk management practices and long-term value creation strategies. This influence is further strengthened when accompanied by media attention, which amplifies public monitoring and external pressure on firms with foreign ownership.

Additionally, Abdelkader (2023) highlights that foreign investors in emerging markets are subject to greater legitimacy pressures due to the liability of foreignness. To maintain global reputation and minimize social and political risks, foreign investors often encourage portfolio firms to improve ESG practices and disclosures. In this context, ESG serves as a legitimacy mechanism that enhances stakeholder trust and strengthens corporate social acceptance.

Consistent with these findings, Zhang & Wu (2024) report that greater levels of foreign ownership are linked to superior ESG performance. Foreign investors contribute not only financial capital but also improved governance standards and increased analyst scrutiny, which in turn enhances transparency and strengthens external monitoring. These mechanisms drive firms to strengthen environmental, social, and governance practices in a more substantive manner, particularly in non-state-owned enterprises that rely more heavily on market-based reputational signals.

Overall, prior studies suggest that foreign ownership enhances ESG performance through a combination of reputational pressure, improved transparency, greater analyst and media attention, and the long term orientation of investors (Abdelkader, 2023; Yu, 2023; Zhang & Wu, 2024).

H<sub>6</sub>: Foreign ownership has a positive effect on corporate ESG performance

## METHODOLOGY

### Population and Research Sample

The initial population of this study consists of all firms listed on the Indonesia Stock Exchange (IDX) during the period 2021–2024. From this population, firms were subsequently filtered based on ESG data availability and completeness of financial and ownership data. The sample was determined using a purposive sampling approach based on several criteria. *First,*

firms are required to have ESG score data that are consistently available during the observation period. *Second*, the firms have complete data: firms must publish complete annual reports throughout the 2021–2024 period, disclose ownership structure information, including institutional and foreign ownership, along with relevant financial data. *Third*, firms with non-negative equity. Based on these selection criteria, a total of 447 firm-year observations were obtained and included in the analysis. The financial data used in this study were obtained from the official website of the Indonesia Stock Exchange. Information on foreign and institutional ownership was collected from the official website the Kustodian Sentral Efek Indonesia (KSEI), which provides detailed records of share ownership structure. In addition, Environmental, Social, and Governance (ESG) data were sourced from katadata.co.id, a reputable Indonesian data and research platform that compiles ESG-related information for publicly listed companies. All data were collected for the period 2021–2024 and were matched across sources to ensure consistency and completeness. Firms with missing ESG data, incomplete financial information, or negative equity were excluded from the final sample (Table 1).

## **Operational Definition of Variables**

### **1. Dependent Variable**

#### **ESG Performance**

The ESG performance reflects a composite indicator of a firm's performance in environmental, social, and governance dimensions. A higher ESG performance signifies a stronger organizational commitment to sustainability, as well as more effective execution of ESG-related policies and practices.

### **2. Independent Variables**

The operational definitions of the variables employed in this study are presented in Table 1. Sharia-compliant firms (SHARIA) or sharia status is measured as a dummy variable, where a value of 1 denotes a sharia-compliant firm, while 0 represents a non-sharia-compliant firm. Profitability is proxied by Return on Assets (ROA), calculated as net income divided by total assets. Leverage is measured using the Debt-to-Equity Ratio (DER), which indicates the proportion of total liabilities relative to shareholders' equity. Firm size (SIZE) is determined using the natural logarithm of total assets. In addition, institutional ownership (INST) is measured as the proportion of outstanding shares held by institutional investors, whereas foreign ownership (FOR) is defined as the percentage of shares owned by foreign investors. A summary of these variable definitions and measurements is provided in Table 2.

### **3. Regression Model**

The regression equation is estimated using robust standard errors to account for potential heteroskedasticity. The regression model is specified as follows

$$ESG_{it} = \beta_0 + \beta_1 SHARIA_{it} + \beta_2 ROA_{it} + \beta_3 DER_{it} + \beta_4 SIZE_{it} + \beta_5 INST_{it} + \beta_6 FOR_{it} + \varepsilon_{it}$$

Where:

$i$  = Firm

$t$  = Years (2021–2024)

$\varepsilon_{it}$  = error term

This model examines the effects of sharia status (SHARIA), profitability (ROA), leverage (DER), and firm size (SIZE), ownership structure (INST and FOR) on ESG performance.

## RESULTS AND DISCUSSION

### Descriptive Statistics

The descriptive statistics indicate considerable variation in ESG performance, firm characteristics, and ownership structure, as presented in Table 3. The average ESG score is 0.3483 with a standard deviation of 0.2359, reflecting a moderate level of ESG performance among listed firms in Indonesia, with values ranging from 0.0200 to 0.9600. The mean value of the SHARIA dummy variable is 0.6443, indicating that approximately 64 percent of the sample is classified as sharia-compliant.

Institutional ownership (INST) records an average of 0.4733, suggesting that institutional investors hold a substantial share of equity in the sampled firms. Meanwhile, foreign ownership (FOR) averages 0.2424, indicating a relatively smaller yet still notable proportion of foreign shareholdings. In terms of financial characteristics, the mean Debt-to-Equity Ratio (DER) is 2.0569, accompanied by a relatively high standard deviation, which reflects significant variation in firms' leverage positions.

Profitability has a mean value of 0.0257, indicating relatively modest profitability levels, with the presence of both profit-generating and loss-incurring firms in the sample. Firm size, proxied by the natural logarithm of total assets (LNCAP), has an average of 30.1597, suggesting that the sample is predominantly composed of relatively large firms, with moderate dispersion across observations.

### Model Selection

In panel data analysis, selecting the appropriate model is essential to obtain reliable estimates. This study considers three alternatives: the Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM). To determine the most suitable model, the Chow test is first applied to compare CEM and FEM, followed by the Hausman test to choose between FEM and REM. The Chow test result shows that the probability value is 0.0000, which is lower than 0.05. Therefore, the null hypothesis is rejected, indicating that the Fixed Effect Model (FEM) is more appropriate than the Common Effect Model (CEM) (Table 4). The Hausman test result indicates that the probability value is 0.0000, which is below 0.05. Thus, the null hypothesis is rejected, suggesting that the Fixed Effect Model (FEM) is preferred over the

Random Effect Model (REM) (Table 5). After selecting the Fixed Effect Model (FEM), diagnostic tests are carried out to ensure the accuracy of the results. Based on Table 6, The multicollinearity test was conducted using the Variance Inflation Factor (VIF). The results show that the VIF values for all independent variables are below the commonly accepted threshold of 10, indicating the absence of serious multicollinearity. Specifically, the VIF values range from 1.07 to 1.47, with a mean VIF of 1.28. These results suggest that the independent variables are not highly correlated and the regression model satisfies the multicollinearity assumption. Meanwhile, to overcome possible heteroskedasticity and autocorrelation issues, this study applies robust standard errors.

### **Regression Results**

The regression results in Table 6 indicate that firm-specific characteristics significantly affect ESG performance, whereas ownership structure variables are not statistically significant. Sharia status has a positive and significant impact, suggesting that sharia-compliant firms tend to achieve higher ESG performance. Institutional ownership and foreign ownership are found to have no statistically significant effect on ESG performance, indicating that ownership structure does not play a decisive role in shaping ESG practices. Profitability is found to have a positive and significant effect, implying that firms with stronger financial performance are more capable of supporting sustainability initiatives. In contrast, leverage does not have a statistically significant effect on ESG performance, suggesting that the level of debt does not systematically influence firms' sustainability practices. Firm size shows the strongest positive influence, reflecting greater public scrutiny and stakeholder pressure on larger firms. Overall, the model is statistically significant with an overall  $R^2$  of 0.1672, indicating that 16.72% of the variation in ESG performance is explained by the included variables (Table 7).

### **Discussion**

#### **Sharia Status on ESG Performance**

The findings of this study indicate that the Islamic label, as reflected by sharia-compliant firms, exerts a positive and statistically significant influence on ESG performance. This result implies that firms categorized as sharia-compliant tend to exhibit higher levels of sustainability performance compared to non-sharia firms, even after controlling for financial and firm-specific characteristics. From a conceptual perspective, this outcome aligns with the notion that adherence to sharia principles, rooted in Maqasid al-Sharia, promotes a balance between economic objectives and social as well as environmental responsibilities. The limitations on excessive leverage, the prohibition of income derived from non-halal activities, and the emphasis on public welfare collectively establish a normative framework that supports stronger

ESG practices, particularly within the environmental and social dimensions (Qoyum et al., 2020; Tariq et al., 2025).

This finding is also consistent with Sharia Enterprise Theory, which posits that the ultimate ownership of all resources belongs to Allah, while humans and business organizations act as trustees. Consequently, the objective of the firm is not limited to profit maximization but extends to the creation of justice and welfare for all stakeholders, including shareholders, employees, society, and the environment. Sharia Enterprise Theory critiques the conventional corporate paradigm that is predominantly capitalistic and often overlooks social and environmental accountability. Within this framework, corporate accountability is twofold, consisting of vertical accountability to Allah as the ultimate owner of entrusted resources and horizontal accountability to humans and nature as beneficiaries. Corporate activities and reporting are therefore viewed as forms of moral and spiritual responsibility that should be guided by values of honesty, justice, and integrity rather than merely fulfilling regulatory requirements or seeking symbolic legitimacy (Widiyanti et al., 2025). Furthermore, the positive relationship found in this study indicates that the Islamic label also functions as a legitimacy mechanism and a reputational signal in the capital market. In the context of an emerging market such as Indonesia, sharia status increases ethical expectations and stakeholder scrutiny toward firms. As a result, firms are encouraged to improve the quality of ESG practices and disclosures in order to maintain legitimacy and strengthen investor trust.

### **Profitability and ESG Performance**

The findings reveal that profitability has a positive and statistically significant impact on ESG performance, in line with prior studies (e.g., Wang et al., 2025). This relationship indicates that firms with stronger financial performance are better equipped to undertake sustainability-related initiatives. Higher profitability reflects more efficient utilization of assets and generates financial slack, enabling firms to allocate resources toward environmental investments, social initiatives, and improvements in governance practices.

Given that ESG initiatives typically involve long-term investments and do not yield immediate financial returns, firms with superior financial performance are more capable of sustaining such commitments. This result is further supported by previous empirical evidence suggesting that profitability enhances ESG performance across environmental, social, and governance dimensions (Carreira & Silva, 2025). From the perspective of legitimacy theory, profitable firms are subject to greater reputational expectations to maintain social legitimacy and stakeholder trust. As a result, they are more inclined to enhance the quality of ESG practices and disclosures as part of their strategic positioning. In this context, ESG performance reflects not only ethical responsibility but also a strategic response to stakeholder expectations.

Furthermore, the findings support the argument that profitability acts as a key enabling factor in corporate sustainability. Firms with higher profitability are better able to meet stakeholder expectations, strengthen corporate reputation, and integrate ESG considerations into long-term strategic decision-making. This result is also consistent with Awaludin et al. (2025), who document that profitability plays a significant role in shaping ESG performance by enhancing firms' ability to respond to stakeholder demands and sustainability challenges.

### **Leverage and ESG Performance**

The results indicate that leverage does not have a statistically significant effect on ESG performance, thus failing to support the hypothesis that leverage negatively influences ESG. This finding suggests that the level of debt financing does not systematically constrain or reduce firms' engagement in sustainability practices. From a theoretical perspective, higher leverage is expected to increase financial pressure and reduce firms' flexibility to undertake long-term investments, including ESG-related activities. However, the insignificant result implies that such financial constraints are not sufficiently strong or universally applicable to influence ESG performance in practice. This finding is inconsistent with prior studies that document a significant negative relationship between leverage and ESG (Awaludin et al., 2025; Likitapiwat et al., 2024; Martiny et al., 2024; Zhang & Wu, 2024).

On the other hand, the relationship between leverage and ESG may be inherently ambiguous. Leverage, commonly proxied by the debt-to-equity ratio, is associated with reduced financial flexibility and increased financial risk, which may limit firms' ability to invest in ESG initiatives (Qoyum et al., 2022). However, as noted by Sitorus et al (2024), when firms rely more heavily on debt financing, creditors become key stakeholders who demand greater transparency regarding financial conditions and sustainability practices. As leverage increases, creditor monitoring intensifies, encouraging firms to enhance transparency through ESG disclosures. This dynamic may offset the expected negative effect of leverage on ESG.

Furthermore, the ambiguous nature of this relationship reflects two opposing mechanisms. On one hand, higher leverage can restrict ESG investment due to limited financial resources. On the other hand, highly leveraged firms have stronger incentives to improve transparency and maintain their reputation through ESG disclosure to preserve creditor confidence and secure continued access to external financing. These countervailing effects may neutralize each other, resulting in a statistically insignificant relationship between leverage and ESG performance.

### **Firm Size and ESG Performance**

Firm size is widely recognized as an important structural determinant in explaining variations in ESG performance. In line with legitimacy theory proposed by Dowling & Pfeffer,

(1975) larger firms tend to face greater public exposure, stronger stakeholder pressure, and more intensive regulatory scrutiny than smaller firms. These conditions encourage large firms to adopt and disclose sustainability practices more extensively as a means of maintaining social legitimacy and protecting corporate reputation. In addition to external pressures, larger firms generally possess stronger financial, organizational, and technological resources that enable them to implement ESG policies more comprehensively. Their larger asset base and financial capacity allow firms to bear the costs associated with ESG implementation, including long term environmental investments, social responsibility programs, and the development of more advanced governance and sustainability reporting systems. Empirical evidence supports this argument, showing that firm size has a positive effect on ESG, reflecting both legitimacy pressures and internal organizational capacity (Wang et al., 2025; Zhang & Wu, 2024).

Although firm size is broadly acknowledged as an important determinant of ESG performance, prior empirical studies also reveal variations in the strength and direction of this relationship. Most studies document that larger firms tend to achieve higher ESG performance due to stronger financial resources, higher public visibility, and greater stakeholder pressure to maintain social legitimacy (Awaludin et al., 2025; Martiny et al., 2024; Qoyum et al., 2020; Salisa et al., 2025; Ye & Sha, 2025; Yu, 2023; Zhang & Wu, 2024). However, some studies suggest that the relationship may not always be linear. Gregory (2022) reports that the strength of the relationship varies depending on ESG rating agencies and industry sectors, and in some cases no significant association is observed. Other evidence suggests a nonlinear relationship in the form of a U-shaped pattern, where small and medium sized firms initially demonstrate relatively stronger ESG performance, while large firms may experience organizational rigidity before improving ESG performance once they reach a certain scale due to increased institutional pressure and resource capacity (Likitapiwat et al., 2024).

Firms with larger asset bases are more capable of undertaking investments in environmental and social initiatives (Arayssi & Tabaja, 2020). Large firms are typically exposed to greater public scrutiny, increased visibility, and more stringent regulatory pressures, which intensify legitimacy demands to demonstrate responsibility across ESG dimensions. Furthermore, they have more substantial financial and organizational resources, enabling them to execute ESG initiatives and sustainability reporting more effectively, consistent with prior empirical evidence (Awaludin et al., 2025; Martiny et al., 2024; Qoyum et al., 2020; Zhang & Wu, 2024).

### **Institutional Ownership and ESG Performance**

The findings of this study indicate that institutional ownership does not exert a statistically significant influence on ESG performance. This result suggests that, within the

sample and observation period, institutional investors have not effectively functioned as an external governance mechanism in promoting corporate sustainability practices. Although institutional investors are theoretically expected to possess monitoring capabilities and ownership power to discipline managerial opportunism, the empirical evidence indicates that such capacity does not necessarily translate into improved ESG performance. This finding is consistent with (Zairin et al., 2025), who report that in emerging markets such as Indonesia, institutional ownership has not yet played an optimal role in enhancing ESG performance, as investors tend to prioritize short-term financial returns, while ESG initiatives are often perceived as additional costs rather than long-term value drivers.

Furthermore, the insignificant relationship between institutional ownership and ESG performance may be attributed to institutional characteristics and regulatory environments in which ESG practices remain largely voluntary. In settings where ESG regulations and enforcement are relatively weak, the monitoring role of institutional investors becomes less effective, limiting their ability to encourage firms to improve environmental, social, and governance practices. Additionally, institutional investors are not a homogeneous group. Without distinguishing between long-term and short-term investors, or between sustainability-oriented and purely financial investors, the overall effect of institutional ownership may become diluted. This argument is supported by prior studies (Mart, 2021; Zairin et al., 2025). that highlight potential nonlinear relationships between ownership structure and ESG outcomes.

These results are also in line with the broader literature suggesting that the relationship between institutional ownership and ESG performance is highly context-dependent and influenced by the level of ownership concentration. In certain cases, the relationship may follow a U-shaped pattern, where ESG performance initially declines at low to moderate levels of institutional ownership and improves only after a critical ownership threshold is reached. Therefore, the findings of this study imply that when institutional ownership remains relatively dispersed and non-dominant, institutional investors may not yet serve as a key driver of ESG performance. Enhancing ESG outcomes thus requires not only ownership structure considerations but also stronger internal governance mechanisms and a more robust regulatory framework that enables institutional investors to exert more effective pressure on corporate sustainability practices.

### **Foreign Ownership and ESG Performance**

The findings of this study reveal that foreign ownership does not have a statistically significant effect on ESG performance. This result indicates that, within the observed sample and period, foreign investors have not effectively acted as an external governance mechanism in promoting corporate sustainability practices. Although foreign investors are generally expected

to introduce stronger governance standards, a longer-term orientation, and greater sensitivity to reputational risks, the empirical evidence suggests that these advantages do not necessarily translate into improved ESG performance. This finding aligns with (Kim, 2025), who argues that foreign ownership does not automatically lead to higher ESG scores or increased ESG investment, and may even impose constraints on ESG initiatives under certain conditions. However, this result contrasts with prior studies that document a positive relationship between foreign ownership and ESG performance (Abdelkader, 2023; Yu, 2023; Zhang & Wu, 2024).

The insignificant impact of foreign ownership may be attributed to limitations in the transmission mechanisms through which foreign investors influence ESG practices, particularly in environments characterized by high information asymmetry. Kim (2025) suggests that in firms with low transparency, the influence of foreign ownership on ESG becomes less effective, as foreign investors face informational constraints that weaken their monitoring capacity. In emerging market contexts, this condition is further exacerbated by relatively weak regulatory frameworks, voluntary ESG disclosure practices, and limited enforcement mechanisms, all of which reduce the effectiveness of external monitoring by foreign investors.

Although foreign investors may introduce higher governance standards and possess the potential to encourage sustainability practices, their actual impact is contingent upon market structure, regulatory quality, and the availability of reliable information. In many emerging markets, foreign investors may not actively engage in monitoring sustainability practices due to limited access to information or a stronger emphasis on short-term investment objectives.

### CONCLUSION

This study examines the determinants of ESG performance among companies listed on the Indonesia Stock Exchange during the 2021 to 2024 period. Using multiple linear regression with robust standard errors on a dataset consisting of 447 firm-year observations, the findings provide several key insights.

The results indicate that sharia stock status has a positive and statistically significant effect on ESG performance, suggesting that firms classified as sharia-compliant demonstrate a stronger commitment to ethical principles, transparency, and sustainability practices. This finding is consistent with the fundamental values of Islamic finance, which emphasize social responsibility, accountability, and ethical business conduct. Furthermore, profitability and firm size are found to have positive and statistically significant effects on ESG performance. Firms with stronger financial performance possess greater financial resources and managerial flexibility to support ESG-related initiatives. In addition, larger firms, due to greater public scrutiny, regulatory exposure, and resource availability, are better positioned to implement ESG practices comprehensively. In contrast, leverage does not have a significant effect on ESG

performance, as its opposing effects of financial constraints and enhanced transparency tend to offset each other. Meanwhile, institutional ownership and foreign ownership are found to have no statistically significant impact on ESG performance. These results suggest that external ownership structures have not yet functioned effectively as governance mechanisms in promoting corporate sustainability practices in the Indonesian context. This study contributes to both theoretical and practical perspectives on ESG research in emerging markets. From a theoretical perspective, the findings suggest that ESG performance is more strongly influenced by internal firm characteristics such as sharia status, profitability, leverage, and firm size than by ownership structure. The positive relationship between the Islamic label and ESG performance supports the argument that Maqasid al-Sharia principles function as a normative and legitimacy based framework that encourages corporate sustainability.

Despite these contributions, several limitations should be considered when interpreting the findings. First, the use of an aggregate ESG score may limit the ability to capture differences across individual ESG dimensions. Second, the relatively short observation period from 2021 to 2024 may not fully reflect the long term effects of corporate sustainability practices. Third, ESG measurement in this study is largely based on disclosure, which may not fully represent the substantive implementation of sustainability initiatives. Finally, ownership structure variables are measured in aggregate form without distinguishing between different types and investment orientations of investors, which may obscure their actual effects in the empirical analysis. Based on these limitations, future research is encouraged to examine ESG dimensions separately to obtain a more detailed understanding of the factors influencing environmental, social, and governance performance. Future studies may also employ longer observation periods and dynamic methodological approaches to better capture causal relationships and long term ESG effects. In addition, incorporating moderating or mediating variables such as internal governance quality, media pressure, and regulatory strength may provide deeper insights into the conditions under which ownership structures become effective in promoting ESG performance. Further research may also distinguish between different types of institutional and foreign investors based on investment orientation and stability, as well as conduct cross country or cross industry comparative studies to enrich understanding of the institutional context shaping the relationship between Islamic labels and ESG performance. Future research may further explore the role of different types of investors and governance mechanisms in influencing ESG performance across industries.

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**FIGURES, GRAPHS, AND TABLES**

Table 1. Sample Selection Process

Description	2021	2022	2023	2024
Total listed firms (IDX)	769	828	906	947
Firms without ESG data	(668)	(704)	(782)	(825)
Firms with incomplete data	(12)	(8)	(0)	(3)
Firms with negative equity	(0)	(1)	(0)	(0)
Final sample	89	115	124	119
Total observations				447

Table 2. Variable and Measurement

Variabel	Measurement	Source
ESG	ESG performance is measured using ESG scores obtained from the Katadata ESG Index (KESGI), which evaluates firms based on environmental, social, and governance dimensions using publicly available data	
SHARIA	1 = sharia-compliant firm (sharia firm) 0 = non-sharia firm	(Qoyum et al., 2020)
ROA	Net profit / total assets	(Wang et al., 2025)
DER	Total debt / total equity	(Qoyum et al., 2020)
SIZE	Natural Logarithm of total assets	(Qoyum et al., 2020)
INST	The percentage of shares held by institutional shareholder	(Zhang & Wu, 2024)
FOR	The percentage of shares held by foreign shareholders	(Yu, 2023) (Nugraheni et al., 2022)

Table 3. Descriptive Statistic

Variable	Obs	Mean	Std. dev.	Min	Max
ESG	447	0.3483	0.2359	0.0200	0.9600
SHARIA	447	0.6443	0.4793	0.0000	1.0000
ROA	447	0.0257	0.0639	-0.2931	0.3420
DER	447	2.0569	3.3250	0.0100	38.5800
SIZE	447	30.1597	1.7301	25.0133	34.7150
INST	447	0.4733	0.3277	0.0000	0.9995
FOR	447	0.2424	0.2615	0.0000	0.9875

Table 4. Chow test

Description	Value
F-statistic	7.65
Prob > F	0.0000

Table 5. Hausman test

Description	Value
Chi-square	45.9
Prob > chi2	0.0000

Table 6. Multicollinearity

SHARIA	1.47	0.68207
ROA	1.07	0.93606

DER	1.37	0.73018
SIZE	1.13	0.88632
INST	1.25	0.79853
FOR	1.37	0.72950
Mean VIF	1.28	

Table 7. Regression Result

Variables	Expected Sign	Coefficient	Robust err.	std. t	P>t	Hypothesis Support
SHARIA	+	0.1609	0.0370	4.35	0.000	Supported
ROA	+	0.0041	0.0015	2.79	0.006	Supported
DER	-	-0.0056	0.0049	-1.14	0.257	Not Supported
SIZE	+	0.2044	0.0533	3.83	0.000	Supported
INST	+	0.1201	0.0656	1.83	0.069	Not Supported
FOR	+	0.0586	0.1791	0.33	0.744	Not Supported
_cons		-6.1240	1.6370	-3.74	0.000	Supported
F		8.24				
Prob		0.00				
R-squared:						
Within		0.2237				
Between		0.1895				
Overall		0.1672				