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Does sustainability pay off for Sharia companies? Unveilling the nexus between sustainability performance and firm value

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ABSTRACT

This study aims to analyze the influence of sustainability on the firm value of Sharia-compliant companies in Indonesia. Panel data regression with a fixed effect model is employed to address this objective. The research findings suggest that sustainability aspects do not significantly affect firm value for several reasons, including a lack of understanding, obstacles during the translation process, uncertainty in the regulatory framework for sustainability projects in Indonesia, and the absence of evident financial rewards for sustainability efforts. Based on these findings, policymakers should proactively encourage the implementation of sustainable practices among Sharia-compliant enterprises in Indonesia. Specifically, education and training programs should be designed to increase the knowledge and comprehension of sustainability principles among corporate executives and staff.

Keywords: Sustainability, Firm Value, Sharia-Compliant Firms, ESG Disclosure, Fixed Effects Model, Regulatory Uncertainty

1. INTRODUCTION

Corporations are increasingly recognizing the importance of sustainability, which signifies a significant change in the economic environment influenced by various interconnected elements. Increasing environmental deterioration and resource depletion have prompted businesses to reevaluate their influence on ecosystems and societies (Winn & Pogutz, 2013). Simultaneously, the rising use of digital media and greater involvement of stakeholders have intensified the pressure on companies to demonstrate their dedication to sustainable practices. Regulatory frameworks and international agreements, such as the Paris Agreement and the United Nations Sustainable Development Goals, have set specific requirements for business sustainability, leading companies to adjust their operations accordingly. Corporations are now integrating sustainability into their business models to reduce risks and attract financing because of the rise in sustainable finance mechanisms and investor demand for ESG-aligned portfolios (Hübel & Scholz, 2019). This increased awareness has important effects in different areas, promoting innovation, improving reputation, and resulting in long-term cost reduction.

Within Sharia-compliant firms, sustainability and environmental performance emphasise a dedication to meeting economic, social, and environmental goals in accordance with Islamic principles. Sustainability involves following Sharia values of justice, transparency, and social responsibility to ensure that company activities not only make a profit but also provide fair advantages to all stakeholders, such as employees, consumers, communities, and the environment (Wadhwa, 2018). Environmental performance requires following Islamic teachings on conservation, protection of natural resources, reduction of emissions and waste, and compliance with environmental legislation. Sharia-compliant companies must follow environmentally friendly business practices, like using renewable energy and clean technologies, while focusing on long-term goals that include human welfare, social justice, and environmental conservation, in accordance with ethical values promoted in Islamic teachings (Erwaedy et al., 2021).

Sustainability in Sharia-compliant enterprises in Indonesia has evolved significantly, demonstrating an increasing acknowledgment of the significance of connecting corporate operations to ethical and environmental factors (Bui et al., 2022). In recent years, these organizations have more frequently incorporated sustainability principles into their operations due to a mix of causes such as governmental mandates, investor requests, and societal norms. This tendency is evident in actions such as adopting responsible investment strategies, implementing environmental management systems, and participating in community development projects. Additionally, the development of Sharia-compliant sustainability indices and certifications has encouraged enterprises to improve sustainability practices.

Eco-efficiency is a crucial factor in assessing the sustainability and environmental impact of businesses. Eco-efficiency focuses on optimizing resource use, reducing environmental impact, and increasing economic value. Eco-efficiency plays a crucial role in assessing how well organizations manage their resources to achieve sustainable results within a sustainability framework. Eco-efficiency helps firms evaluate their environmental performance in relation to their economic output by analyzing the ratio of outputs (products and services) to inputs (raw materials and energy). This analysis helps identify opportunities for improvement and innovation. Eco-efficiency is strongly related to environmental stewardship and corporate social responsibility. It encourages businesses to seek tactics that enhance profitability while reducing ecological impact and promoting long-term sustainability. Eco-efficiency is a crucial indicator of a company's commitment to sustainable development, demonstrating its ability to balance economic progress with environmental conservation and societal well-being.

The integration of eco-efficient practices holds substantial promise for enhancing firm value, particularly within Sharia-compliant enterprises. As an essential component of sustainable business strategies, eco-efficiency optimizes resource utilization and minimizes environmental impacts, thereby fostering operational resilience and cost savings (Korhonen & Seager, 2008). For Sharia-compliant companies, which operate within the ethical framework of Islamic principles, eco-efficiency aligns closely with the mandate of responsible stewardship of resources as bestowed by Sharia law. By prioritizing eco-efficient practices such as energy conservation, waste reduction, and sustainable sourcing, Sharia-compliant companies can not only mitigate environmental risks but also bolster their reputation as socially responsible entities, thereby attracting ethical investors and enhancing shareholder value (Lee & Isa, 2022). Moreover, the adoption of eco-efficient measures facilitates compliance with Sharia principles, such as the prohibition of wastefulness (Israf) and the promotion of environmental conservation (Hifz al-bay'a) (Nasir et al., 2022). Consequently, by integrating eco-efficiency into their operations, Sharia-compliant companies can achieve synergies between sustainable practices and Sharia compliance, thereby enhancing their overall competitiveness and long-term value.

Several studies have identified a favorable correlation between sustainability and corporate value. Loh et al. (2017) and Yu & Zhao (2015) discovered a significant correlation between business value and sustainability reporting and performance. Yu and Zhao (2015) observed a stronger market reaction in nations with robust investor protection and high disclosure levels. Lo and Sheu (2007) found a notable positive correlation between business sustainability and market value, with a robust interaction between sustainability and sales growth. Research on the impact of sustainability issues on the value of Sharia-compliant enterprises in Indonesia is limited. This study examines how sustainability, as defined by eco-efficiency, affects the firm value of Sharia-compliant enterprises in Indonesia.

2. LITERATURE REVIEW

2.1 The Stakeholder Theory

Stakeholder theory encourages corporations to look beyond maximizing profits and examine the wider impact of their actions on stakeholders (Gatti & Ondersma, 2020). Managers are encouraged to take a more comprehensive approach to decision-making by clearly defining the company's goals and focusing on creating and preserving value for stakeholders. This strategy involves assessing not just financial gains but also taking into account the social, environmental, and ethical consequences of their choices. Stakeholder theory underscores the interdependence of different stakeholders and stresses the significance of cultivating mutually advantageous relationships with them (Jones et al., 2018). By doing this, organisations may effectively traverse intricate business environments, reduce risks, and capitalise on possibilities that stem from a thorough comprehension of stakeholder requirements and concerns.

Stakeholder theory promotes a fair assessment of the interests of all stakeholders, acknowledging that their requirements may differ and need to be carefully reconciled (Ramakrishnan, 2019). Sustainable practices, including ecologically responsible production processes, ethical sourcing, and community engagement activities, serve to align various interests and promote long-term value generation. Companies can improve their resilience, reputation, and competitive edge by incorporating sustainability into their business plans. Sustainable practices reduce hazards related to environmental degradation and social unrest while simultaneously creating opportunities for growth and innovation (Shao, 2020). By examining how sustainability factors affect a company's value using stakeholder theory, researchers can better understand how firms can successfully manage both financial goals and social/environmental obligations, promoting sustainable growth and lasting success.

2.2 The Legitimacy Theory

The legitimacy theory highlights the complex connection between enterprises and the societies they function in, stressing the significance of upholding societal acceptability and support (Rendtorff, 2019). Companies must show their commitment to societal norms and values, such as environmental stewardship, in order to maintain their legitimacy within this social compact. Companies frequently utilize tactics focused on environmental performance and disclosure to validate their operation. These tactics help corporations align their activities with social expectations and serve as mechanisms to bridge legitimacy gaps resulting from inconsistencies between their actions and societal standards. Sustainability strategies, especially those focused on eco-efficiency, are crucial for increasing legitimacy in this setting (Arslan et al., 2021). By incorporating eco-efficient methods, organizations enhance their environmental performance and demonstrate their dedication to sustainable development, thereby strengthening their credibility with stakeholders.

Furthermore, the connection between eco-efficiency and a company's worth within the legitimacy framework goes beyond symbolic actions. Implementing eco-efficient methods can provide concrete advantages to companies, such as reduced costs, improved operational efficiency, and increased competitiveness. Companies can create long-term value by investing in eco-efficiency to meet public expectations and sustain credibility (Burnett et al., 2011). Companies can enhance their financial performance and meet societal responsibilities by lowering resource use, minimizing waste, and managing environmental risks. The correlation among eco-efficiency, legitimacy, and business value highlights the strategic significance of sustainability in promoting societal acceptance and economic prosperity. Studying the relationship between eco-efficiency and firm value through the legitimacy theory offers valuable insights on how companies can manage societal expectations, environmental responsibility, and financial performance to attain sustainable growth and resilience

2.3 Maqasid Al-Shariah

Maqasid al-Shariah, or the objectives of Islamic law, provide a comprehensive framework within which Sharia-compliant companies operate, encompassing not only legal principles but also broader ethical, social, and economic goals. In the context of sustainability, maqasid al-Shariah serves as a guiding principle that directs companies towards actions that promote the well-being of individuals, communities, and the environment (Yaakub & Abdullah, 2020). The pursuit of sustainability aligns closely with several key objectives of Sharia law, including the preservation of life (hifz al-nafs), protection of the environment (hifz al-bay'a), and promotion of social justice (hifz al-'irdh). Therefore, Sharia-compliant companies are encouraged to adopt sustainable practices that uphold these objectives, such as ethical sourcing, fair treatment of employees, environmental conservation, and community development initiatives. By prioritizing sustainability in their operations, Sharia-compliant companies not only fulfill their religious and ethical obligations but also contribute to broader societal welfare, in line with the overarching objectives of Sharia law (Nasir et al., 2022). This integration of maqasid al-Shariah with sustainability principles reinforces the intrinsic connection between Islamic values, responsible business practices, and long-term sustainable development for Sharia-compliant companies.

2.4 Sustainability Aspect on Firm Value

Implementing sustainability practices, such as eco-efficiency and waste reduction, in organizations can save operational expenses over time and enhance the company's reputation with stakeholders. Implementing sustainable practices improves a company's ability to withstand environmental hazards and laws and broadens access to finance, ultimately boosting firm value.

A range of studies has found a positive relationship between sustainability and firm value. Umaraite (2022) and Yu (2015) found that sustainable development and sustainability performance positively impact firm value. This is further supported by Abdioğlu (2020), who found that firms listed in the BIST Sustainability Index have higher values. However, Nguyen (2020) found a negative relationship between firm value and adherence to the Global Reporting Initiative (GRI) sustainability reporting guidelines. These findings suggest that while sustainability can enhance firm value, the specific mechanisms and contexts in which it occurs require further investigation. A range of studies have explored the impact of sustainability on firm value in Sharia companies. Ammer (2020) and Younis (2023) found a positive association between environmental sustainability practices and firm value in Saudi Arabia, with Ammer highlighting the role of independent directors in enhancing this relationship. However, Alsahlawi (2021) found a negative impact of environmental sustainability disclosure on stock returns, particularly in firms with financial constraints. Lee (2022) extended this research to Malaysian Shariah-compliant companies, finding a positive relationship between ESG practices and financial performance. These findings suggest that while sustainability practices can enhance firm value in Sharia companies, the specific mechanisms and contexts of this relationship require further investigation.

3. METHOD

This study utilises a quantitative methodology to investigate how sustainability impacts the firm value of sharia-compliant enterprises in Indonesia. This study uses secondary data from annual and sustainability reports published by the Indonesia Stock Exchange (IDX) and the official websites of pertinent companies. Stock prices are sourced from data provided by Yahoo Finance. This study focuses on all Sharia-compliant companies listed in the Indonesia Sharia Stock Index (ISSI) from 2017 to 2021. The cross-sectional data sample consists of 30 Sharia-compliant firms from the Indonesia Sharia Stock Index (ISSI). The annual time-series data sample covers the years 2017 to 2021, depending on the availability of annual and sustainability reports from each selected firm. The sample selection was performed using the purposive sampling method, focusing on companies listed in the ISSI between January 2017 and December 2021 that have issued annual and sustainability reports from 2017 to 2021.

In line with the research objective, this study employs firm value (FV) as the dependent variable and sustainability (ECO) as the independent variable. Additionally, several control variables are included, such as Return on Equity (ROE), leverage (LEV), return on assets (ROA), Firm Size (SIZE), and Investment Opportunity Set (IOS). See Table 1.

Table 1. Data Source

No	Variable	Unit	Measurement	Source
1	FV	Score	Firm value measured by Tobin's Q ratio	IDX
2	ECO	Biner (0 or 1)	Eco-Efficiency measured by ISO 14001	Sustainablity Report
3	ROE	%	Return on Equity	IDX
4	LEV	Score	Leverage	IDX
5	ROA	%	Return on Asset	IDX
6	SIZE	USD	Firm Size	IDX
7	IOS	Score	Investment Opportunity Set	IDX

This study conducted an inference analysis by creating a panel data regression model to examine how sustainability impacts the firm value of Sharia-compliant enterprises in Indonesia. According to Baltagi (2005), in the regression of panel data, three models can be utilized: the Error Component Model or Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM). The stages in the analysis to create a panel data regression model that will be carried out in this study are as follows:

$$FVit = \alpha + \beta 1ECOit + \beta 2ROEit + \beta 3LEVit + \beta 4ROAit + \beta 5SIZEit + \beta 6IOSit + \mu it$$

Before conducting model selection tests, a regression equation is first formulated from the chosen model resulting from the tests. This selected model will then be utilized to analyze the regression outcomes of the research variables.

4. RESULT AND DISCUSSION

4.1 Result

The descriptive statistics indicate that Unilever Tbk earned the highest firm value of 23.29 in 2017, whereas Polychem Indonesia Tbk recorded the lowest company value of 0.39 in 2019. The average firm valuation from 2017 to 2021 is 2.27. The findings show that the average company value of Sharia-compliant enterprises in Indonesia is regarded as pricey, being overvalued as it surpasses 1 (see Table 2).

Table 2. Descriptive Statistic

Variable	Mean	Std. Error	Min	Max
FV	2.26	3.28	0.39	23.29
ECO	0.53	0.50	0	1
ROE	12.12	30.73	-110.27	145.09
LEV	0.96	1.01	0.08	6.18
ROA	6.36	10.24	-25.1	46.52
SIZE	32.96	47.26	1.2	277.2
IOS	4.82	11.68	0.25	82.02

To perform the regression analysis, many tests, such as the Chow and Hausman tests, are necessary to select the optimal model among the Common Effect Model (CEM), Fixed Effect Model (FEM), or Random Effect Model (REM) (See Table 3).

Table 3. The Results of the Chow Test and the Hausman Test

Test	H-Alternative	Chi Sq	p-Value
Chow Test	Significant individual effects (FEM)	0.0000	0.0000*
Hausman Test	One model is inconsistent (FEM)	34.49	0.0000*

*significance level 0.05

The test results indicate that the Fixed Effect Model (FEM) is the ideal model. The random effect model regression results are as follows:

Table 4. Fixed Effect Model (FEM)

Variable	Coefficien	Std. Error	p-value
ECO	0.0034	0.3657	0.992
ROE	-0.0507	0.0060	0.000*
LEV	-0.8029	0.1098	0.000*
ROA	0.1278	0.0148	0.000*
SIZE	0.0001	0033	0.980
IOS	0.2821	0.0124	0.000*

*significance level 0.05

Based on the above in Table 4, it is found that sustainability measured through eco-efficiency (ECO) has a probability value of 0.992, indicating that this variable does not have a significant influence on the firm value of Sharia-compliant companies in Indonesia. A similar situation is observed with one of the control variables, namely firm size (SIZE). However, the other variables, namely Return on Equity (ROE), Leverage (LEV), Return on Asset (ROA), and Investment Opportunity Set (IOS), each have a probability value of 0.000, indicating that they have a significant influence on the firm value of companies in Indonesia.

The R-Square value in this study model is 0.8359, which is equivalent to 83.59%. Approximately 83.59% of the variation in firm value of Sharia-compliant enterprises in Indonesia can be accounted for by the independent variables in the model. The high R-Square value indicates that the chosen factors together possess a strong ability to explain the fluctuations seen in firm value. Thus, the model seems to be strong in depicting the connections between the independent and dependent variables being studied.

4.2 Discussion

Sustainability has become a crucial factor for enterprises globally, covering environmental, social, and economic aspects. Lately, sustainability has been a prominent topic of discussion, leading corporations to incorporate sustainable practices into their corporate plans. In Indonesia, sustainability practices in Sharia-compliant enterprises have gained recognition for their compatibility with Islamic ideals that advocate for social justice, environmental care, and economic prosperity. Research suggests that the influence of sustainability, namely eco-efficiency, on the value of Sharia-compliant enterprises in Indonesia is still restricted, despite the increasing focus on this aspect.

Various underlying variables affect the limited impact of sustainability on the firm value of Sharia-compliant enterprises in Indonesia. There is a significant lack of awareness and understanding about the importance of sustainability in these businesses. Although sustainability has been introduced, there may still be a lack of deep understanding regarding its potential to enhance the total value proposition of organisations (Bertoni, 2017). The lack of comprehension may result from various factors such as inadequate education and training on sustainable concepts, cultural beliefs, or limited exposure to successful sustainability projects in the corporate sector (Gambini, 2006).

Implementing sustainable concepts into Sharia-compliant enterprises may face obstacles during the translation process. Although there is a desire and dedication to implement sustainable practices, the execution of these strategies may not achieve maximum efficiency due to several limitations (Bengtsson et al., 2018). These limits may vary from limitations in resources, such as financial and human capital, to difficulties in incorporating sustainable practices into current corporate operations. The conservative nature of Sharia-compliant company practices, which prioritise stability and risk prevention, may create obstacles for implementing new sustainability measures that are viewed as risky.

The regulatory framework for sustainability projects in Indonesia may lack clarity and incentives to encourage wider implementation among Sharia-compliant enterprises. Regulatory uncertainty or inconsistent enforcement may discourage corporations from making substantial investments in sustainability due to concerns about possible legal or financial consequences (Durugbo & Amankwah-Amoah, 2019). The absence of government-provided incentives, such tax breaks or subsidies for sustainable projects, could discourage corporations from prioritising sustainability in their strategic planning.

The lack of evident financial rewards for sustainability efforts may also weaken the impact of sustainability on a company's worth (Umaraite & Lapinskaitė, 2022). Companies may find it challenging to allocate resources to sustainability efforts if the financial advantages of adopting sustainable practices are not easily visible or quantifiable within traditional financial frameworks. Within Sharia-compliant organisations, financial decisions are frequently influenced by ethical considerations in addition to economic concerns.

The research results indicate important implications for future research and practices in the realm of sustainability and Sharia-compliant businesses in Indonesia. There is an urgent want for more research to enhance the comprehension of sustainability concepts and their impact on company value in Sharia-compliant firms. Comprehensive studies are needed to examine the intricate connections between sustainable practices and financial success, taking into account the distinct ethical framework and commercial climate of Sharia-compliant firms. Future research should concentrate on implementing sustainability strategies in Sharia-compliant enterprises, exploring effective implementation methods and identifying hurdles to their adoption. Researchers can offer useful insights into how sustainability enhances company value and drives long-term success in Sharia-compliant businesses by filling these knowledge gaps.

Policymakers should proactively encourage the implementation of sustainable practices among Sharia-compliant enterprises in Indonesia based on research findings. Education and training programmes should be specifically designed to increase knowledge and comprehension of sustainability principles among corporate executives and staff. This may entail creating tailored training programmes, workshops, and educational campaigns that emphasise the advantages and optimal methods of sustainability. Policymakers can think about introducing incentive mechanisms like tax breaks, subsidies, or preferred procurement regulations to promote sustainable business practices among enterprises that show outstanding sustainability performance. Regulatory improvements are necessary to ensure clarity and uniformity in the regulatory framework related to sustainability activities. Policymakers should focus on simplifying permit procedures, specifying reporting obligations, and guaranteeing uniform enforcement of environmental laws to establish a supportive framework for sustainable economic operations. Capacity building and technical assistance programmes should be created to help Sharia-compliant enterprises overcome obstacles to implementing sustainability measures. This may include granting access to technical knowledge, financial support for sustainability initiatives, and advice on incorporating sustainability into business plans. Policymakers can promote the incorporation of sustainability into Sharia-compliant firms in Indonesia by implementing these policy proposals. This can lead to economic growth, social development, and environmental sustainability in accordance with Islamic principles.

5. CONCLUSION

The research concludes that sustainability has not had a major effect on the company value of Sharia-compliant enterprises in Indonesia. The minimal impact can be ascribed to issues such as lack of awareness and understanding of sustainability concepts, challenges in implementing sustainable initiatives, legislative ambiguities, and the lack of explicit financial rewards. There is an urgent requirement for additional study to enhance the comprehension of how sustainability impacts the value of Sharia-compliant enterprises, combined with proactive policies to encourage sustainability adoption. Policymakers and stakeholders can promote sustainability in Sharia-compliant companies by implementing focused education, incentive systems, regulatory changes, and capacity-building programmes. This will help align economic development with social and environmental responsibility based on Islamic values.

Ethical Approval
Not Applicable

Informed Consent Statement
Not Applicable

Disclosure Statement
The Authors declare that they have no conflict of interest

Data Availability Statement
The data presented in this study are available upon request from the corresponding author for privacy.

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Notes on Contributors

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