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Dividend policy and ESG disclosure substitution: Evidence from Malaysia

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Abstract

In markets characterised by information asymmetry, investors do not share equal access to firm-specific information, leading to uncertainty regarding a company's true value (Malik & Kashiramka, 2025). Signaling theory posits that firms undertake observable actions to reduce such uncertainty and enhance credibility (Connelly et al., 2011; Hasan & Al-Najjar, 2025). Within this framework, dividend policy has long been recognised as a key financial signal and reflects the extent to which firms prioritise shareholder returns over earnings retention (DeAngelo et al., 2000; AlGhazali et al., 2023). Dividend payments can therefore serve as credible indicators of firm and managerial quality, particularly when alternative disclosures are limited or less reliable (Bhattacharya, 1979; Salvi et al., 2023).

Extending this perspective beyond financial signals, firms are increasingly expected to provide transparent and credible ESG disclosures to reduce information asymmetry in investment decisions (Chen et al., 2024). ESG broadly captures how firms manage environmental impact, stakeholder relationships, and governance structures (Gherghina, 2024). Specifically, environmental dimension relates to resource use and emissions, the social dimension concerns stakeholder welfare, and the governance dimension reflects leadership quality and ethical conduct (Aydoğmuş et al., 2022).

At the global level, mandatory ESG disclosure is intended to reduce information gaps and enhance comparability across firms (Krueger et al., 2024). In Malaysia, the introduction of the National Sustainability Reporting Framework (NSRF) on 24 September 2024 by the Securities Commission Malaysia marks a significant regulatory shift. However, prior practices were largely shaped by a weakly regulated environment. In the pre-NSRF period, the absence of uniform standards and weak enforcement limited the comparability and reliability of ESG disclosures,

constraining their effectiveness in mitigating information asymmetry (Almulhim et al., 2024). Under such conditions, disclosure inconsistencies are not merely incidental but structural, potentially prompting firms to rely on alternative signals to convey credibility.

Within the Malaysian context, these dynamics highlight the relevance of signal substitution in markets with evolving ESG practices. Dividend policy can function as a substitute, with higher payouts compensating for weaker ESG transparency (Ananzeh et al., 2024), or as a complement, where stable dividends reinforce strong ESG disclosure (Wan Mohammad & Wasiuzzaman, 2021). Malaysia thus provides a timely setting to examine how firms strategically deploy financial and non-financial mechanisms to mitigate information asymmetry.

This study addresses this gap by empirically testing whether dividend policy functions as an alternative signal to ESG disclosure among Malaysian listed firms. It focuses on three research questions: (1) Does the level of ESG disclosure affect dividend payout policy? (2) Do firms with lower ESG transparency pay higher dividends, consistent with a substitution effect? (3) Do firms with higher ESG transparency also exhibit higher dividend payouts, indicating complementarity?

In line with these questions, the study sets out three objectives. The first is to examine the relationship between ESG disclosure levels, proxied by the ESG disclosure ratio and Controversies-adjusted ESG (ESGC) score, and dividend payout policy. The second is to test whether firms with lower ESG transparency use higher dividend payouts as a substitute signaling mechanism. The third is to assess whether firms with higher ESG transparency exhibit higher dividend payouts, indicating a complementary signaling effect.

Examining the link between dividend payout and ESG transparency requires an integrated theoretical perspective. This study draws on signaling theory, agency theory, and stakeholder theory to develop testable hypotheses.

Spence (1973) develops signalling theory to explain how firms convey unobservable attributes to markets under conditions of information asymmetry. Financial and non financial disclosures reduce this asymmetry by transmitting information to investors (Dumay, 2016; Dua & Sharma, 2024). In Malaysia, highly leveraged firms continued paying dividends during the COVID-19 period to signal financial stability and maintain investor confidence (Syarifah & Hersugondo, 2024). In ESG studies, higher ESG scores are linked to more stable dividend policies, indicating a complementary relationship between ESG disclosure and dividend payouts (Casey, 2020; Ismillah & Faisal, 2023).

Agency theory complements signalling theory by viewing dividends as a mechanism to align managerial and shareholder interests and reduce agency conflicts arising from managerial opportunism (Jensen, 1986). By distributing excess cash, dividend payments limit the resources available for potential misuse by insiders. Firms with higher ESG scores are therefore expected to pay higher dividends (Verga Matos et al., 2020).

Stakeholder theory highlights firms' responsibilities to multiple stakeholder groups (Donaldson & Preston, 1995; Freeman, 2010). Zahid et al. (2023) show that firms prioritising ESG initiatives combined with higher dividend payouts help align the interests of diverse stakeholder groups.

Similarly, Shehata et al. (2025) find a significant positive relationship between ESG scores and dividend payouts in stakeholder-oriented firms.

While ESG disclosure captures planned reporting of ESG practices, it does not fully reflect market perceptions when adverse events occur. ESG controversies, defined as negative events or disclosures related to ESG practices, indicate failures in responsible conduct and draw stakeholder scrutiny (Dorfleitner et al., 2020; Schiemann & Tietmeyer, 2022). Unlike voluntary disclosure, they represent realised risks that increase uncertainty, erode trust, and may influence dividend decisions as firms seek to restore credibility (Aouadi & Marsat, 2018; DasGupta, 2022). This highlights the importance of incorporating ESG controversies when examining ESG-related signalling.

Empirical studies present two views on the ESG–dividend relationship. The complementary view links stronger ESG performance to higher and more stable dividends through improved governance, lower risk, and stronger stakeholder confidence (Bilyay-Erdogan et al., 2023; Hampl & Vágnerová Linnertová, 2025), a pattern more evident in developed markets than in emerging economies with uneven disclosure quality. The substitution view suggests that dividends may offset weak ESG disclosure, particularly in emerging markets, where firms adjust payouts to maintain investor confidence (Grullon & Michaely, 2002; Akpadaka et al., 2024). These findings indicate that dividends function as either substitute or complementary signals depending on ESG disclosure quality, supporting the formulation of three hypotheses.

The hypotheses in this study distinguish between a general association and two competing explanations of firm behaviour. The first hypothesis (H1) proposes that ESG disclosure is significantly associated with dividend payout, without specifying the direction of the relationship. The substitution hypothesis (H2) predicts a negative relationship between ESG disclosure and dividend payout, where firms with weaker ESG transparency pay higher dividends to compensate for limited non-financial disclosure. In contrast, the complementarity hypothesis (H3) predicts a positive relationship, indicating that firms with stronger ESG transparency also pay higher dividends to reinforce investor confidence through consistent signaling.

To test these hypotheses, the study employs two regression models using alternative ESG measures. The first model uses the ESG disclosure ratio, which captures the extent of ESG information disclosed and serves as a proxy for disclosure intensity and transparency. The second model uses the ESGC score, which incorporates both ESG disclosure quality and adjustments for corporate controversies and therefore represents a quality-adjusted measure of ESG performance. Using both measures helps ensure that the empirical results are robust across different dimensions of ESG transparency.

The estimated coefficient signs are used to distinguish between the competing explanations. A negative relationship supports the substitution view grounded in agency and stakeholder theories, where dividends act as a substitute mechanism to compensate for weaker ESG disclosure and reduce investor uncertainty. A positive relationship supports the complementarity view consistent with signaling theory, where firms with stronger ESG

performance pair higher-quality ESG disclosure with higher dividend payouts to strengthen investor confidence.

The models tested in this study are specified as follows:

Model 1
$DIV_{it} = \beta 0 + \beta 1\ ESG\ Disclosure\ Score_{it} + \beta 2\ Control_{it} + \varepsilon_{it}$

Model 2
$DIV_{it} = \beta 0 + \beta 1\ ESGC\ Score_{it} + \beta 2\ Control_{it} + \varepsilon_{it}$

Dividend policy (DIVit) is measured using the dividend payout ratio for firm i in year t. ESG transparency is proxied by the ESG disclosure score (ESG Disclosure Scoreit) and the controversies-adjusted ESG score (ESGC Scoreit). The ESG disclosure score is constructed from LSEG raw ESG data based on publicly available disclosures. Each item within the Environmental (306 items), Social (278 items), and Governance (177 items) pillars is coded as 1 if disclosed and 0 otherwise. Pillar scores are computed as the proportion of disclosed items, and the overall ESG disclosure score is obtained as the average of the three pillar scores. The ESGC score is obtained directly from LSEG.

The study controls for firm characteristics that may influence dividend payout. Profitability (Profitabilityit) is included since more profitable firms tend to generate higher free cash flowand are more likely to pay dividends (Januarsi & Sanusi, 2024). It is measured by return on assets. Leverage (Leverageit) is considered because higher debt can restrict dividend payments when lenders impose constraints to protect their interests (Nasrulloh, 2024). It is measured as total liabilities divided by total assets. Firm size (Sizeit) is included as larger firms are generally more likely to pay dividends (Sirait et al., 2025). It is measured as the natural logarithm of total assets. Growth opportunities (Growthit) are captured based on the firm life-cycle hypothesis, where firms with stronger growth prospects tend to retain earnings rather than distribute them (Thapa, 2021). Growth is proxied by the market-to-book ratio.

The study employs panel regression analysis using firm-level data over time. All models include firm fixed effects to control for time-invariant unobserved heterogeneity and year fixed effects to capture unobserved time-specific macroeconomic shocks affecting all firms. Standard errors are clustered at the firm level to account for serial correlation and heteroskedasticity. Observations with missing values in key variables are excluded using listwise deletion. To reduce the influence of extreme values, all continuous variables are winsorised at the 1st and 99th percentiles.

The empirical analysis draws on panel data from firms listed on the Main Market of Bursa Malaysia, excluding financial services firms, over the period 2018 to 2024. ESG coverage for Malaysian firms becomes more complete after 2017, making this period suitable for analysis. Financial firms are excluded because they operate under distinct regulatory frameworks and accounting practices, which limit comparability with non financial sectors. All data are sourced from the LSEG database.

This study contributes by providing empirical evidence on signaling substitution between ESG disclosure and dividend policy in an emerging market with uneven ESG reporting, offering insights into how firms manage information asymmetry through payout decisions.

Keywords:
Dividend policy; ESG controversies; Signalling theory; Substitution effect; Complementary effect

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