

Environmental social and governance (ESG) and profitability

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International Journal of Science and Research Archive, 2026, 20(01), 971–975

Publication history: Received on 15 June 2026; revised on 27 July 2026; accepted on 29 July 2026

Article DOI: <https://doi.org/10.30574/ijrsra.2026.20.1.1556>

Abstract

In today's competitive business landscape, Environmental, Social, and Governance (ESG) considerations have evolved from a niche concern to a central component of corporate strategy. While many companies initially viewed ESG as a compliance burden or public relations tool, a growing body of evidence reveals a powerful truth: strong ESG performance is closely linked to enhanced financial returns and profitability. This article explores the compelling connection between responsible business practices and the bottom line, providing insights for anyone looking to thrive in an increasingly sustainability-focused world. The growing awareness and concern surrounding Environmental, Social, and Governance (ESG) issues is increasingly evident on a global level. Environmental aspects focus on how a company manages its energy use and the waste it generates, as well as the broader environmental impact of its operations. Social aspects involve how a company interacts with its stakeholders, including both directly and indirectly connected groups. Governance refers to the strategies a company employs to meet its responsibilities, ensuring adherence to ethical business practices and compliance with relevant laws and regulations.

Keywords: Environment; Social; Governance; Profitability; Firm value; Profitability.

1. Introduction

Global challenges related to environmental degradation, social inequality, and inadequate corporate governance have fundamentally transformed traditional business paradigms, replacing the former “business as usual” model of shareholder value maximization with a broader stakeholder-oriented approach where employees, customers, investors, regulators, and international authorities now expect companies to operate sustainably and generate positive societal impact beyond financial profit alone [2]. The interconnectedness of climate and energy crises with all economic sectors has made sustainability, corporate social responsibility, and responsible investment critically important across industries, with banks in particular shifting toward sustainability initiatives to rebuild reputation and public trust lost after the 2008 financial crisis, while investors increasingly demand access to both financial and non-financial information to construct more resilient portfolios. In this environment, sustainability reporting initially voluntary and separate from mandatory financial statements has gained prominence, converging under the framework of Environmental, Social, and Governance (ESG) reporting, where strong ESG performance yields improved reputation, stronger market positioning, and better financial results, whereas poor ESG risk management leads to higher operational costs, reputational damage, and reduced profitability [2,3]. Some experts suggest that incorporating ESG factors enhances financial performance by effectively managing long-term risks, while others argue that emphasizing sustainability could potentially reduce profitability, making ESG a subject of ongoing debate without clear consensus, particularly as investor behavior evolves beyond traditional metrics like dividend yield and valuation to increasingly consider environmental impact and governance practices [8]. Despite this shift, limited research directly compares the financial performance of ESG-oriented firms with non-ESG firms, especially within developing economies. Climate change has emerged as one of the most pressing global challenges, with the World Economic Forum's Global Risks Report [3] ranking climate-related risks among the top threats demanding immediate action, as global temperatures

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have already risen approximately 1.1°C above pre-industrial levels [3]. Beyond environmental consequences, climate change poses profound risks to the business sector, as many corporate activities contribute directly to environmental degradation through greenhouse gas emissions, making companies both contributors to and potential victims of climate impacts, with firms that fail to adapt facing severe financial consequences including asset damage, supply-chain disruptions, increased operating costs, regulatory penalties, and lasting reputational harm. This evolving risk landscape has driven a fundamental shift in corporate awareness: long-term viability now depends on embracing sustainable development and aligning strategies with the United Nations Sustainable Development Goals (SDGs), requiring comprehensive reorientation of business models and value-creation processes [20]. Sustainable investment has demonstrated strong outperformance in recent years, as evidenced by the SRI-KEHATI Index in Indonesia comprising companies selected for strong sustainability practices, which delivered a cumulative return of 87.15% from December 2013 to December 2023, significantly outperforming the broader Jakarta Composite Index (70.16%) and the LQ45 Index (36.48%), underscoring a growing preference among investors for sustainable and responsibly governed companies [14]. A robust body of empirical research consistently demonstrates that strong ESG performance is linked to superior financial results, with Chen et al. [5] describing a “promotion effect” whereby high ESG engagement enhances a firm’s financial position and market valuations, and Friede et al. [9] analyzing over 2,000 studies to conclude that approximately 90% identify a non-negative relationship between ESG factors and financial performance, with a clear majority showing positive effects. However, the relationship continues to be a topic of active research, with Loong et al. [12] revealing nonlinear, threshold-based effects where the environmental pillar positively influences profitability only up to a certain threshold beyond which additional improvements yield diminishing or even negative returns, the social pillar drives profitability only after surpassing a minimum threshold, and the governance pillar exhibits context-dependent effects, highlighting the double-edged nature of ESG engagement where excessive or unbalanced investment can lead to over-investment and reduced financial returns. The rapid growth of ESG funds has drawn significant interest, with Hoepner and McMillan highlighting that these funds can deliver competitive financial returns, yet a key challenge arises from the risk that financial institutions may misrepresent or distort the true ESG characteristics of products as a marketing tactic, underscoring the urgent need for stronger regulatory oversight to guarantee authenticity and transparency [7]. Empirical evidence from diverse contexts shows varying results: Hikmah and Daljono [11] found that ESG disclosure exerts a statistically significant positive influence on firm value among Indonesian companies, while Rahmadani et al. [16] reported that industry type and retention ratio exert significant negative effects on ESG performance with no significant impact from independent commissioners or return on assets. Chen et al. [5] find that superior ESG performance enhances stock liquidity by lowering agency costs and attracting greater foreign investment. Palupi et al. [13] found that dividend policy, overall ESG score, environmental pillar score, and profitability each have statistically significant effects on stock liquidity, while social and governance pillar scores show no significant influence, suggesting that particular attention should be given to the environmental component of ESG. Terdpaopong et al. [23] studied 385 Thai companies and found that higher ESG disclosure is positively associated with Tobin’s Q but not with return on assets, and strikingly, when earnings per share increases, firms with high and medium ESG disclosure levels experience a decline in Tobin’s Q whereas firms with low ESG levels see an increase, challenging the prevailing assumption that ESG disclosure uniformly benefits firm value. Hadi and Kaban [10] investigated Sharia-compliant companies in Indonesia and found that profitability and leverage exert significant positive influence on firm value, but ESG disclosure shows no significant impact, suggesting that investors continue to prioritize traditional financial performance indicators. Amato et al. (2024) employed advanced machine learning models on approximately 400 EuroStoxx 600 companies and demonstrated that ESG scores emerge as robust and highly relevant predictors of earnings before interest and taxes, often outperforming or complementing traditional accounting variables. Smaoui et al. [22] studied 67 banks across 13 countries and found a significant positive relationship between overall ESG engagement and bank performance driven predominantly by the governance pillar, with strong governance significantly enhancing profitability and efficiency of Islamic banks while exhibiting no comparable effect on conventional banks, underscoring structural differences between banking models. Rohmah et al. [19] found that agency costs exert a significant direct effect on firm value, while ESG disclosure and financial distress show no significant direct impact, but profitability significantly mediates the relationships between ESG disclosure and firm value and between agency costs and firm value, indicating that positive effects of higher ESG disclosure are realized primarily through improved profitability. Rizqo and Qadri [18] found that environmental, social, and governance pillars each have statistically significant positive effects on firm profitability, implying that strong ESG performance constitutes a valuable strategic resource that enhances financial outcomes. Abdullah et al. [1] revealed a significant positive relationship between strong ESG performance and superior financial performance, greater market competitiveness, and higher levels of employee commitment among Chinese non-financial companies. Yustin and Suhendah [24] found that company age has a positive effect on ESG disclosure while profitability exhibits a negative and significant relationship with ESG disclosure among Indonesian manufacturing firms, implying that more profitable firms disclose less ESG information. Pyka et al. [15] found a negative impact of ESG activities, particularly in social and governance dimensions, on bank profitability measured by return on assets and return on equity, while some ESG efforts show positive association with financial stability, pointing to a growing divergence between short-term profitability and long-term stability. Rahmah

et al. [17] revealed a negative and significant relationship between ESG disclosure and firm value, but profitability and firm size mitigate this negative effect, indicating that the market does not always respond positively to ESG disclosures. Bressan [3] analyzed global property and casualty insurers and found that insurers with high ESG scores tend to pay more taxes and exhibit lower profitability compared to low-ESG counterparts. Cesarone [4] introduced a multi-objective portfolio optimization model and found that in U.S. markets, portfolios with higher ESG constraints tended to outperform others in recent periods, while in European markets, applying ESG constraints did not consistently enhance profitability. Setioko et al. [21] found that ESG performance and capital structure have significant positive impacts on firm value, with profitability serving as an effective mediating variable. Collectively, these findings are grounded in three theoretical frameworks: signaling theory [3] which focuses on reducing information asymmetry between insiders and outsiders through voluntary disclosure; legitimacy theory which emphasizes the social contract between organizations and society, where voluntary disclosure of social and environmental performance strengthens the corporate “license to operate” [4] and stakeholder theory [17] which holds that companies should create value for all stakeholders rather than prioritizing only shareholder interests, with transparent disclosure shaping positive stakeholder perceptions that ultimately contribute to improved company performance [6]. Given this complex and often contradictory evidence, the present review systematically synthesizes the literature to clarify the conditions under which ESG performance enhances or diminishes corporate profitability and firm value.

2. Method

This study conducts a systematic literature review synthesizing peer-reviewed empirical and theoretical research on the ESG–corporate profitability relationship, following established integrative review guidelines. Articles were identified from Scopus, Web of Science, and Google Scholar using search terms including “ESG,” “profitability,” “firm value,” “return on assets,” “Tobin’s Q,” and “sustainability reporting,” limited to peer-reviewed journals, conference proceedings, and working papers published between 1992 and 2025. Included studies empirically examined ESG–financial performance links using quantitative methods with appropriate econometric techniques (panel regression, GMM, SEM, threshold models) and provided clear statistical results; theoretical papers without empirical testing and non-peer-reviewed reports were excluded. From an initial pool of approximately 120 articles, 24 met the inclusion criteria. Key data extracted included author, country context, sample size, ESG measurement, profitability proxies, econometric methods, main findings, and moderating variables. Studies were evaluated on methodological rigor including endogeneity-correcting techniques and sample size adequacy; no studies were excluded solely for non-significant or negative findings to ensure balanced synthesis.

3. Results

The synthesis reveals that the ESG–profitability relationship is predominantly positive but exhibits significant variation across geographic contexts, industry sectors, time horizons, and methodological approaches. Friede et al. [9], analyzing over 2,000 studies, concluded that approximately 90% report a non-negative relationship, with the clear majority showing positive effects. Chen et al. [5] described a “promotion effect” whereby high ESG engagement enhances financial position and market valuations. In emerging markets, the positive relationship is particularly pronounced. Rizqo and Qadri [18] demonstrated that all three ESG pillars have significant positive effects on profitability using panel data from 55 Indonesian companies. Setioko et al. [21] reported that ESG performance and capital structure significantly increase firm value with profitability as a mediating variable. The SRI-KEHATI Index delivered a cumulative return of 87.15% from December 2013 to December 2023, outperforming the Jakarta Composite Index (70.16%) and LQ45 index (36.48%) [14]. In China, Abdullah et al. [1] identified a significant positive relationship between strong ESG performance and financial performance among non-financial firms (2016–2022).

However, several short-term studies found predominantly neutral effects. Terdpaopong et al. [23] examined 385 Thai listed companies and found that while higher ESG disclosure is positively associated with Tobin’s Q, no significant relationship exists with return on assets; critically, when earnings per share increases, firms with high/medium ESG disclosure experience a decline in Tobin’s Q, whereas low-disclosure firms see an increase. Adding further complexity, Loong et al. [12] employed dynamic threshold panel regression on Asian energy companies and revealed distinct nonlinear patterns: the environmental pillar positively influences profitability only up to a certain threshold, beyond which returns diminish or become negative; the social pillar drives profitability only after surpassing a minimum threshold; and the governance pillar exhibits similar context-dependent effects. Several studies reported negative or non-significant effects under specific conditions. Bressan [3] found that global property and casualty insurers with high ESG scores tend to pay more taxes and exhibit lower profitability. Hadi and Kaban [10] found no significant impact of ESG disclosure on firm value for Sharia-compliant Indonesian companies. Yustin and Suhendah [24] reported that profitability has a negative relationship with ESG disclosure among Indonesian manufacturing firms. Rahmah et al. [17]

documented a negative direct relationship between ESG disclosure and firm value, though profitability and firm size mitigate this effect. Pillar-specific effects showed substantial heterogeneity. Smaoui et al. [22] reported that strong governance significantly enhances profitability for Islamic banks but has no comparable effect on conventional banks. Palupi et al. [13] found that only the environmental pillar has a significant effect on stock liquidity.

4. Discussion

The synthesized findings confirm that the ESG–profitability relationship is predominantly positive yet significantly more nuanced and context-dependent than often portrayed. Supporting signaling theory, strong ESG performance reduces information asymmetry, as evidenced by the SRI-KEHATI Index's outperformance [14]. Stakeholder theory is reinforced by studies showing that robust ESG practices enhance customer loyalty, workforce commitment, and innovation capacity [1]. Several critical moderating factors explain apparent contradictions. First, time horizon proves decisive: short-term studies frequently report neutral or weakly negative effects because ESG investments entail upfront costs with deferred benefits, whereas long-horizon analyses consistently show positive effects. Second, regional context systematically moderates outcomes: U.S. markets show positive effects in recent periods, European markets demonstrate mixed results, and emerging markets more consistently exhibit positive effects, likely because ESG adoption remains selective. Third, the relationship is fundamentally nonlinear with identifiable thresholds [12]. This threshold-based resolution explains why high-ESG insurers in Bressan [3] exhibit lower profitability they may have exceeded optimal environmental investment levels. Disaggregating individual pillars reveals that governance consistently emerges as the strongest, most reliable positive driver of financial performance. The environmental pillar exhibits clear threshold patterns and strongest stock liquidity effects [13]. The social pillar shows highly variable effects: positive in most emerging markets but negative in some European contexts.

Notably, Terdpaopong et al. [23] found that when earnings per share increases, high-ESG disclosure firms experience a decline in Tobin's Q, suggesting markets may interpret high ESG spending as a signal that management is diverting funds from value-creating activities. Rahmah et al. [17] documented a direct negative relationship between ESG disclosure and firm value, implying that smaller or less profitable firms face greater market skepticism. From a theoretical perspective, legitimacy theory explains why older firms disclose more ESG information, yet Yustin and Suhendah [24] paradoxically found that more profitable manufacturing firms disclose less, suggesting a "legitimacy surplus." The mediating role of profitability is critical: Rohmah et al. [19] demonstrated that profitability significantly mediates the ESG disclosure firm value relationship, indicating that ESG investments generate valuation primarily through improved operational profitability. For practitioners, firms should pursue strategic, threshold-aware ESG investment rather than indiscriminately maximizing aggregate scores. Managers should prioritize governance improvements, invest in environmental initiatives only until marginal benefits diminish, recognize that social investments require surpassing minimum thresholds, and align ESG intensity with firm size and profitability profile. For investors, ESG should be integrated as a long-term valuation factor with attention to pillar-level details and regional context. For policymakers, the finding that mandatory ESG disclosure can negatively affect firm value suggests that phased implementation with sector-specific thresholds and complementary incentives is preferable to universal mandates.

5. Conclusion

This review confirms that ESG performance and corporate profitability are not opposing forces but can be mutually reinforcing when ESG investments are strategically calibrated, industry- and region-appropriate, and integrated with core business operations. The triple bottom line people, planet, and profit remains achievable, but the path is neither automatic nor uniform. Governance offers the clearest win-win opportunities; social and environmental dimensions require careful threshold management. The central implication is clear: optimize ESG intelligently, not maximize blindly.

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