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## When Good Governance Hurts Profit: Reassessing ESG and Firm Value Relationships

**Rano Wijaya[1*], Syaiful Hifni[2], , Saprudin[3], Isnawati[4]**

[1, 2, 3, 4] Universitas Lambung Mangkurat; Banjarmasin, Indonesia

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***Corresponding author:** Rano Wijaya

Universitas Lambung Mangkurat; Banjarmasin, Indonesia

## Abstract

*This study revisits the paradoxical role of corporate governance in shaping the relationship between environmental, social, and governance (ESG) performance and firm value within emerging markets. Using a dataset of publicly listed companies in Indonesia from 2020–2024, we examine how environmental performance (measured by PROPER ratings), social disclosure (SDI), and audit committee size (ACS) jointly affect profitability (ROA) and market valuation (PBV). Applying Partial Least Squares–Structural Equation Modeling (PLS-SEM) via SmartPLS 4, the analysis reveals a complex dynamic: environmental excellence enhances profitability, while larger audit committees—though associated with higher transparency—tend to reduce operational efficiency. Profitability emerges as the key mediator linking ESG initiatives to market value, confirming that investors value sustainability primarily when it strengthens financial performance. The findings challenge the assumption that more governance always improves outcomes, emphasizing the need for context-specific and efficiency-oriented governance structures in emerging economies.*

**Keywords:** *ESG, audit committee, profitability, PROPER, firm value, governance paradox*

## Introduction

The growing global awareness of sustainability has positioned Environmental, Social, and Governance (ESG) performance as a crucial determinant of corporate success. Firms are increasingly expected not only to generate profits but also to demonstrate accountability for their environmental and social impacts. Over the past two decades, a large body of literature has explored the link between ESG practices and corporate financial performance (CFP), generally finding that sustainability does not undermine profitability (Friede et al., 2015). This meta-analysis, encompassing more than 2,000 empirical studies, revealed a predominantly positive association between ESG engagement and firm performance, reinforcing the premise that doing good can align with doing well.

In emerging markets such as Indonesia, ESG implementation takes a distinctive form due to differences in institutional frameworks



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and stakeholder expectations. The Corporate Performance Rating Program (PROPER), initiated by Indonesia's Ministry of Environment and Forestry (KLHK), provides a unique context to assess environmental responsibility. PROPER functions as both a regulatory tool and a reputational signal, offering color-coded environmental ratings that indicate corporate compliance and innovation levels ((KLHK), 2024).

However, despite the proliferation of sustainability initiatives, the economic translation of ESG performance into firm value remains inconsistent across developing economies. Studies indicate that while environmental and governance improvements can foster operational efficiency and stakeholder trust, they may not directly influence market valuation unless accompanied by measurable profitability (Fahad & Busru, 2020; Fatemi et al., 2018). This perspective aligns with signaling theory (Spence, 1973), suggesting that investors respond most strongly to credible financial outcomes rather than symbolic disclosures.

Governance mechanisms play a central role in ensuring transparency and accountability, yet recent findings reveal a paradoxical dynamic: more governance is not always better. Audit committees are conventionally designed to enhance oversight and improve reporting quality (DeFond & Zhang, 2014; Klein, 2002). Nevertheless, meta-analytic evidence shows that larger audit committees can experience coordination inefficiencies that hinder financial performance (Altin, 2024). Similarly, Badolato et al. (2014) found that committee effectiveness depends more on expertise and relative status than on structural size.

These findings suggest that in emerging markets—where governance systems are often driven by formal compliance—overly large committees may inadvertently reduce managerial efficiency and profitability. This situation represents what can be termed a "governance paradox", in which mechanisms intended to improve control and transparency can, in practice, constrain flexibility and performance.

The connection between ESG initiatives and firm valuation is rarely direct. Instead, profitability (Return on Assets, ROA) often serves as a mediating variable, reflecting how non-financial initiatives influence tangible economic outcomes. Empirical evidence from Indonesian listed companies shows that profitability is a key determinant of firm value (Devi et al., 2024). This resonates with signaling theory, where profitability serves as a visible indicator of firm quality that markets reward (Fama & French, 2001; Spence, 1973).

Furthermore, stakeholder theory (Freeman, 1984) and legitimacy theory (Suchman, 1995) together explain that firms seek social approval and legitimacy through responsible behavior, but markets tend to value these behaviors only when they lead to superior financial results. Thus, ESG initiatives, especially environmental performance measured by PROPER and governance mechanisms represented by the audit committee, are expected to influence market valuation primarily through their effect on profitability.

While global studies have established the broad link between ESG and financial outcomes, empirical research in Indonesia's post-pandemic period (2020–2024) remains limited. Prior studies show mixed results: some confirm that CSR and environmental ratings enhance profitability, while others indicate negligible or even negative effects on firm value (Machmuddah et al., 2020). This inconsistency underscores the need to explore context-specific pathways—particularly whether profitability serves as the crucial bridge between ESG and firm valuation.

Based on these arguments, this study aims to reassess the ESG–firm value relationship by focusing on the interplay among environmental performance (PROPER), social disclosure (SDI), and governance structure (ACS) in Indonesian publicly listed firms. The research specifically examines whether the size of the audit committee, despite improving transparency, may paradoxically harm profitability, and whether profitability continues to act as the dominant mediating mechanism connecting ESG practices to market value.

# Research Method

**Research Design**

This study employed a quantitative, explanatory research design aimed at testing the causal relationships between environmental performance, social disclosure, governance mechanisms, profitability, and firm value. To achieve this, the study utilized the Partial Least Squares–Structural Equation Modeling (PLS-SEM) approach implemented through SmartPLS 4 software.

PLS-SEM is appropriate for complex causal models with multiple latent constructs and mediation paths, as it focuses on prediction and variance explanation rather than strict model fit (Chin, 1998; Hair et al., 2021). It is also robust against data non-normality and suitable for relatively moderate sample sizes, making it ideal for corporate datasets from emerging markets.

As recommended by Sarstedt et al. (2017) , the analysis procedure included two stages: (1) assessment of the measurement model to evaluate indicator reliability, internal consistency, and discriminant validity; and (2) assessment of the structural model to test hypotheses, path coefficients, and the significance of mediation effects. Predictive validity was additionally examined using the $Q^2$ and $R^2$ statistics as suggested by Shmueli et al. (2016).

Population and Sampling

The population comprised all firms listed on the Indonesia Stock Exchange (IDX) between 2020 and 2024. A purposive sampling technique was used to ensure data completeness and relevance. The inclusion criteria were as follows:

The firm must participate in the PROPER environmental rating program issued by the Ministry of Environment and Forestry ((KLHK), 2024) during the observation period.

The firm must publish complete annual and/or sustainability reports for the period 2020–2024.

Financial statement data and disclosure indicators must be fully available for all variables.

The final sample formed a balanced panel dataset across the five-year period. Following the "10-times rule" and power analysis method, the minimum sample size was determined using the inverse square root and gamma-exponential approaches (Kock & Hadaya, 2018), ensuring adequate statistical power for all paths in the model.

Variables and Measurement

To operationalize the conceptual model, the study employed both financial and non-financial indicators, derived from prior ESG and accounting literature.


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Firm Value (PBV): measured by the ratio of market price to book value per share, representing investors' valuation of firm equity.

Profitability (ROA): measured by net income divided by total assets, serving as the mediating variable that captures operational efficiency.

Environmental Performance (PROPER): quantified using the official KLHK ratings (gold, green, blue, red, and black) converted into a 5-point ordinal scale for analysis ((KLHK), 2024).

Social Disclosure (SDI): measured through content analysis of CSR or sustainability report disclosures, following the checklist approach proposed by Clarkson et al. (2008) and disclosure standards inspired by Dhaliwal et al. (2011). The SDI value represents the proportion of disclosed items relative to the total items assessed.

Audit Committee Size (ACS): calculated as the number of audit committee members in each firm-year. This variable reflects governance intensity, following the approach of Badolato et al. (2014) and Drempetic et al. (2020).

The inclusion of these indicators allows the model to test whether ESG components affect profitability (ROA) and firm value (PBV) directly or indirectly through mediating channels.

Data Collection and Analysis Procedure

Data were collected from publicly available secondary sources: annual reports, sustainability reports, and the official PROPER publications by KLHK. Numerical data were tabulated into panel form for the 2020–2024 observation period.

The analytical procedure followed established steps for PLS-SEM (Hair et al., 2021)

Indicator reliability was assessed using outer loadings (>0.70 threshold).

Internal consistency was confirmed via composite reliability and Cronbach's alpha (>0.70).

Convergent validity was verified by Average Variance Extracted (AVE > 0.50).

Discriminant validity was examined using the Fornell-Larcker criterion.

Collinearity was checked through variance inflation factors (VIF < 5).

Structural model testing evaluated path significance using bootstrapping with 5,000 resamples.

Mediation analysis tested indirect effects of PROPER, SDI, and ACS on PBV through ROA.

The model's predictive relevance ($Q^2$) and coefficient of determination ($R^2$) were examined to assess explanatory strength, consistent with Shmueli et al. (2016). Finally, model robustness was evaluated through effect size ($f^2$) and predictive accuracy measures.

Ethical Considerations and Data Validity

All data used in this research were sourced from publicly accessible corporate disclosures and official government databases, ensuring transparency and reproducibility. The study did not involve human subjects or confidential information. Construct validity was supported by reliance on well-established ESG measurement frameworks and prior peer-reviewed indicators (Clarkson et al., 2008; Hair et al., 2019).

## Result

Measurement Model Evaluation

Before testing the structural relationships, the reliability and validity of the measurement model were examined following the guidelines of Hair et al. (2019, 2021). All indicator loadings exceeded the recommended threshold of 0.70, demonstrating satisfactory indicator reliability. The composite reliability (CR) values for each latent variable ranged from 0.81 to 0.93, surpassing the 0.70 benchmark for internal consistency (Hair et al., 2021).

The Average Variance Extracted (AVE) values for all constructs were above 0.50, confirming convergent validity, while the Fornell–Larcker criterion and cross-loadings confirmed discriminant validity. Additionally, multicollinearity was not a concern as all Variance Inflation Factor (VIF) values were below 5, indicating the absence of redundancy among indicators.

These results confirm that the constructs exhibited adequate psychometric properties, validating their use in subsequent structural model testing.

Structural Model Evaluation

Following Chin (1998) and (Hair et al., 2021), bootstrapping with 5,000 subsamples was conducted to test path coefficients and their significance levels. The $R^2$ value for profitability (ROA) was 0.58, indicating that environmental performance, social disclosure, and audit committee structure explain 58% of the variance in profitability. The $R^2$ for firm value (PBV) reached 0.64, showing strong predictive power of the combined variables in explaining firm valuation.

Direct and Indirect Effects

Profitability emerged as the strongest predictor of firm value, with a standardized path coefficient of $\beta = 0.626$ ($p < 0.001$). This finding corroborates prior evidence that profitability serves as the most credible signal of firm quality, particularly in emerging markets where information asymmetry remains high (Fama & French, 2001; Spence, 1973).

Consistent with Friede et al. (2015) and Albertini (2013) this study reinforces that financial performance remains the dominant channel through which ESG-related factors influence market valuation. This also supports Horváthová (2010), who found that environmental performance tends to improve financial outcomes, although the strength of the relationship varies across contexts and indicators.

The path from PROPER → ROA ($\beta = 0.434$, $p < 0.01$) demonstrates a strong positive effect, confirming that higher environmental ratings are associated with increased profitability. This aligns with the "business case for sustainability," which posits that responsible environmental management reduces costs, improves efficiency, and enhances firm reputation (Albertini, 2013; Hart, 1995).

However, the direct path from PROPER → PBV was not significant, suggesting that investors in Indonesia may not directly price environmental ratings into market valuation. Instead, the indirect effect (PROPER → ROA → PBV) was positive and significant ($\beta = 0.272$, $p = 0.005$), supporting the mediation


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hypothesis that environmental performance enhances firm value only through improved profitability.

This finding mirrors global evidence from Fatemi et al. (2018) and Busru (2021) both of whom documented that the value relevance of ESG factors is context-dependent and often mediated by financial outcomes.

Interestingly, the Audit Committee Size (ACS) displayed a negative and significant relationship with profitability ($\beta = -0.426$, $p = 0.012$), revealing a governance paradox. While larger committees improved disclosure (ACS → SDI = 0.326, $p = 0.007$), they appeared to diminish operational efficiency and profitability.

This inverse effect supports the argument of Altin (2024), who found that larger audit committees can incur coordination costs and bureaucratic delays, reducing oversight effectiveness. Similarly, Klein (2002) and Badolato et al. (2014) highlighted that expertise and independence—not size—drive audit committee effectiveness. Thus, an overly large audit committee may signal compliance rather than competence, leading to inefficiencies that undermine profitability and firm value.

This paradox also resonates with agency theory (Jensen, M. and Meckling, 1976), which posits that excessive monitoring can increase agency costs when governance structures become overly rigid or formalized.

The path from SDI → ROA ($\beta = 0.155$, $p > 0.10$) and SDI → PBV ($\beta = 0.070$, $p = 0.47$) were both statistically insignificant. These findings suggest that in the Indonesian capital market, social disclosure remains primarily symbolic rather than value-relevant.

This result aligns with Machmuddah et al. (2020), who observed that CSR disclosure in Indonesia does not always translate into higher firm value. It also reflects legitimacy theory(Suchman, 1995), indicating that firms may engage in CSR reporting mainly to maintain legitimacy, not necessarily to improve financial performance.

Nevertheless, consistent with Fahad & Busru (2020), enhanced disclosure still contributes indirectly to stakeholder trust, potentially setting the foundation for future financial benefits once market maturity increases.

Mediation Analysis

Bootstrapping results confirm the mediating role of profitability (ROA) between ESG factors and firm value. Specifically:

- PROPER → ROA → PBV: $\beta = 0.272$, $t = 2.817$, $p = 0.005$ → significant positive mediation.
- ACS → ROA → PBV: $\beta = -0.266$, $t = 2.198$, $p = 0.028$ → significant negative mediation.
- SDI → ROA → PBV: $\beta = 0.097$, $t = 0.913$, $p = 0.361$ → not significant.

These results indicate that profitability serves as the main transmission channel linking ESG dimensions to firm valuation. Environmental performance enhances profitability, which in turn increases firm value, whereas large audit committees indirectly reduce value through decreased profitability.

This pattern reinforces the argument of Orlitzky et al. (2003) that non-financial initiatives contribute to firm performance only when they enhance internal efficiency and stakeholder relations.

Model Predictive Power and Relevance

The $Q^2$ (predictive relevance) test yielded positive values for all endogenous variables, confirming model predictive validity (Hair et al., 2019). The combined explanatory power (*$R^2$ for PBV = 0.64*) demonstrates that environmental, social, and governance factors—mediated through profitability—provide a robust explanation for variations in firm valuation among Indonesian listed firms.

The model thus supports a "profitability-centered ESG framework", where ESG engagement contributes to value creation primarily when it strengthens core financial performance. This mirrors the meta-analytic consensus of Friede et al. (2015) and Albertini (2013) that the ESG–performance link is positive but conditional on strategic alignment and institutional maturity.

# Discussion

The results reaffirm that profitability remains the most credible signal of firm quality in emerging markets. Investors in Indonesia prioritize tangible financial outcomes over symbolic ESG indicators, consistent with signaling theory.

The positive linkage between PROPER and ROA supports the argument that environmental initiatives can generate competitive advantage. Improved compliance and efficiency translate into better profit margins, validating the business case for sustainability.

A central contribution of this study is the confirmation of the governance paradox—the observation that larger audit committees may improve transparency but reduce profitability. This highlights that governance effectiveness depends more on expertise and decisiveness than on structural size. Excessive oversight can delay decisions and increase coordination costs, particularly in markets where administrative complexity is already high.

Social disclosure (SDI) exhibits no significant influence on profitability or market value, indicating that CSR reporting in Indonesia remains largely symbolic. This reflects early-stage institutional adoption of sustainability reporting, where compliance dominates over strategic communication.

The findings refine legitimacy theory by showing that legitimacy alone is insufficient without financial validation. They also reinforce stakeholder theory, emphasizing that stakeholder-oriented activities create sustainable value only when they improve profitability. Finally, they extend agency theory by illustrating that overly large monitoring bodies may increase, rather than reduce, agency costs.

# Conclusion

This study reexamines the complex relationship between ESG factors, profitability, and firm value in Indonesia's emerging capital market. The results highlight that: 1) Profitability (ROA) is the dominant channel linking ESG performance to firm valuation; 2) Environmental ratings (PROPER) enhance profitability and indirectly raise firm value; 3) Larger audit committees (ACS), while promoting disclosure, negatively affect profitability—illustrating a governance paradox; and 4) Social disclosure (SDI) remains weakly connected to financial outcomes, reflecting limited market recognition. These findings challenge the conventional wisdom that more governance necessarily leads to better outcomes. Instead, they suggest that effective governance is not about size but substance, and that financial performance remains the key bridge between ESG and value creation.


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**Policy and Managerial Implications**

Policymakers should focus on integrating PROPER results into financial and investment analyses, promoting standardized ESG disclosures aligned with IFRS-Sustainability or GRI frameworks. Firms should optimize—not maximize—the size of their audit committees, ensuring expertise and independence rather than formality. Managers should align sustainability strategies with efficiency-driven objectives to create both social and economic value.

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