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The impact of corporate sustainability performance on capital structure: A literature review

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Abstract

The aim of this article is to analyse the impact of corporate sustainability performance on capital structure, based on a review of recent literature and empirical studies. The article discusses how environmental, social and governance (ESG) factors influence corporate financial decisions, particularly the debt-to-equity ratio. Research shows that higher levels of ESG disclosure often led to lower cost of capital, lower financial leverage and greater investor confidence. ESG performance is becoming an indicator not only of reputation but also of financial efficiency, as transparency and responsible performance reduce risk and improve access to finance. The article highlights that the impact of sustainability factors on capital structure depends on the sector, region and size of the company, therefore it is important to assess these aspects in a contextual way. The article concludes that sustainable performance and ESG integration are becoming a cornerstone in shaping a modern, resilient and competitive capital structure.

Keywords: capital structure, ESG, debt, equity, sustainability information, sustainability activities, WACC, financial leverage.

1. Introduction

Sustainability of corporate activities is increasingly becoming one of the most important factors in the analysis of companies. Global challenges such as climate change, social inequality and resource use have led to both investors and consumers paying more attention not only to the financial performance of companies, but also to the responsibility of organizations in the areas of environment, social well-being and governance (ESG). This transformation affects various aspects of corporate activities, including their financial decisions, as well as the formation of capital structure.

Capital structure is the ratio between a company's debt and equity sources used to finance its activities. Traditional theories, such as the Modigliani–Miller theorem or the trade-off theory, explain capital structure choices mainly based on financial and tax efficiency arguments. However, in the modern business environment, aspects of sustainability activities are also becoming a significant factor affecting financing decisions.

An increasing number of studies in scientific literature examine how the level of sustainability activities affects the ability of companies to attract new capital and

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improve investor confidence. Even in older articles, some scholars reveal that high levels of sustainability performance can reduce the cost of financing due to lower risk perception, higher creditor and investor confidence (Atan et al., 2016; Goss & Roberts, 2011), while other lines of research draw attention to the potential costs associated with implementing sustainability initiatives (Barnea & Rubin, 2010).

Empirical research also shows that ESG disclosure can reduce the cost of capital and encourage companies to choose lower financial leverage. For example, a meta-analysis covering data from more than 60,000 companies showed that all three ESG dimensions significantly reduce the cost of capital and improve corporate performance (Saini et al., 2025).

Similarly, Ellili (2020) found that ESG disclosure and institutional governance in the United Arab Emirates have a negative impact on the cost of capital, encouraging a more efficient capital structure.

It is also important to note that ESG disclosure can act as a signal to investors about a company's long-term stability and risk management capabilities. Li et al. (2018) showed that ESG risk changes the optimal capital structure, as investors demand higher returns from companies that do not adhere to sustainability principles. Thus, ESG disclosure is becoming an increasingly important factor in shaping companies' strategic financing. Research shows that companies facing high ESG risks are more likely to choose a more conservative capital structure in order to maintain investor confidence.

Given these empirical studies, it becomes evident that ESG disclosure is an integral part of modern capital structure formation, and ESG reporting has become a popular topic in recent years due to the increasing attention of key societal actors to sustainability and accountability (Tawfiq et al., 2024). The objective of this article is to analyse the impact of corporate sustainability activities on capital structure.

2. Literature review

2.1. Corporate sustainability performance

Corporate sustainability is increasingly recognized as an essential part of modern business practice. Sustainability refers to a company's efforts to integrate ESG considerations into its strategy and daily operations to create long-term value for shareholders and stakeholders, and ESG criteria are becoming a key indicator for investors and creditors to evaluate corporate performance. Sustainability is closely linked to risk management and long-term business value creation (Eccles et al., 2014).

In 1983, the United Nations General Assembly established the World Commission on Environment and Development, which later became known as the Brundtland Commission. In 1987, the Commission published the Brundtland Report, Our Common Future. It built on what had been achieved in Stockholm and provided the most politically significant of all definitions of sustainable development: The concept of sustainability gained political momentum during that period, but some critics

argue that the concept of sustainability presented in the Brundtland Commission report is overly optimistic and vague.

For example, Stoddart (2011), unlike the Brundtland Commission, defines sustainability as the efficient and equitable distribution of resources between generations, while carrying out social and economic activities within the limits of a limited ecosystem. On the other hand, Ben-Eli (2015) considers sustainability as a dynamic equilibrium occurring in the process of interaction between a population and its environment. Based on this approach, Thomas (2015) argues that sustainability focuses on human activities and their ability to satisfy human needs and desires without depleting or exploiting available productive resources.

Thus, a sustainable population must develop in such a way as to express its full potential without causing irreversible negative impacts on the environment, however, as the analyzed scientific works show, the concept of "sustainability" is a broad, ambiguous and all-encompassing word. Sustainability is used to refer to everything that is required to make a decision related to social, economic and environmental impacts (Rahman et al., 2022). Based on this aspect, sustainability can also be defined as the ability to make responsible decisions in the use and allocation of resources for economic and non-economic activities to achieve some desired social, economic and environmental outcomes.

One of the most prominent theories defining sustainability – the three-pillar theory (TPL) – was developed by John Elkington in 1994. He firmly stated that sustainability should be understood and assessed simultaneously taking into account the three environmental, economic and social spheres. Based on TPL, sustainable development is today seen as an area that overlaps between the three spheres of development – economic, ecological and community.

Sandberg (2015), states that it is based on these spheres that the principles of sustainable development are distinguished, which can be defined as the main and guiding ideas that govern actions. They are related to ethics and culture and act as reference points for behavior. According to Atan et al. (2016), companies that actively develop sustainability strategies not only reduce operational risks, but also secure more favorable financing conditions and strengthen their market positions. Sustainability activities also become an important factor in shaping the company's reputation, which can have a long-term positive impact on the trust of investors, consumers and other stakeholders.

Companies, in line with their social responsibility, must also disclose sustainability information in their reports. Sustainability disclosure is the process by which organizations provide information related to the environmental, social and governance impacts of their operations. Sustainability disclosure is necessary to achieve greater transparency, responsibility and provision of information to investors, consumers and other stakeholders. Therefore, in Lithuania, the new provisions oblige large companies and companies whose securities are traded on regulated markets (except for very small companies) to provide information on sustainability issues in their management reports. It is noteworthy that as the EU market, finance and economy transform into sustainable ones, the need for and importance of information

on sustainability issues will grow. When making decisions regarding a company, consumers will want to base their decisions not only on financial statement information, but also on sustainability information. It is likely that over time, information on sustainability issues will become even more important than information on financial statements. Companies that operate sustainably and prepare information on sustainability issues will gain an increasing competitive advantage over time - they will receive financing more easily, will be considered an attractive employer, and customers will be more willing to purchase goods and services (Ministry of Finance of the Republic of Lithuania, 2026).

To manage climate risks and promote a green economy, both international institutions and national regulators are actively demanding high-quality sustainability information. In Lithuania, information on the preparation of sustainability reporting by companies and groups of companies, their submission to the Register of Legal Entities, publication on the company's website, and ensuring sustainability reporting is provided by the Green Finance Institute; the Audit, Accounting, Asset Valuation and Insolvency Management Service (AVNT) and the Lithuanian Chamber of Auditors (Ministry of Finance of the Republic of Lithuania, 2026).

Further, I will discuss in more detail the latest scientific research that the disclosure of ESG indicator information in corporate reports is also becoming not only a matter of reputation, but also a strategic and regulatory requirement. Companies are increasingly faced with the need to provide comprehensive, reliable and comparable ESG information, as this is required by both investors and regulatory authorities. In summary, ESG disclosure in corporate reports is becoming an integral part of modern business practice. This not only meets growing regulatory requirements, but also creates value through transparency, trust and long-term responsible growth.

2.2. Capital structure

Capital structure is defined as the proportion of a company's sources of financing – debt and equity (Jaros, Bartosova, 2015). In other words, it is the ratio between liabilities to creditors and shareholders, which shows how a company finances its operations and investments.

From a theoretical point of view, Modigliani and Miller presented the classical principles of capital structure, stating that under perfect market conditions (when there are no taxes, bankruptcy costs, information asymmetry), capital structure does not affect the value of the company. However, in the real world, when taxes, bankruptcy risk and agency problems exist, the choice of capital structure becomes a strategic decision that can significantly affect the efficiency and risk of the company's operations (Jaros, Bartosova, 2015).

A company's debt is sometimes confused with its liabilities. However, there is an important difference between operating liabilities and debt obligations. Loth (2025) states that operating liabilities are the costs that a company must pay to operate its

business, such as salaries. Thus, when it comes to the components of the capital structure, only debt obligations are considered, not operating liabilities. However, there is debate over the category of “debt obligations.” Not all analysts agree on what exactly debt obligations are. Some analysts define the debt component of the capital structure as long-term debt on the balance sheet. However, other analysts consider this definition to be overly simplistic. They believe that the debt component of the capital structure should consist of short-term loans, long-term debt, and two-thirds of the amount of operating leases and redeemable preferred stock. This is considered to be a more comprehensive view of the total amount of debt a company has (Loth, 2025).

Thus, we can agree that capital in the context of a company includes all the financial resources that a company uses to finance its activities – it can be both equity (shareholder investments, retained earnings) and debt capital (loans, bonds). According to Gratton (2025), the capital structure reflects how a company pays its bills – whether it relies more on borrowed funds or on investor capital. This structure is a strategic decision that depends on the company’s risk tolerance, growth opportunities and economic conditions.

It is important to note that the appropriate capital structure is not the same for all companies – it depends on the sector, the nature of the business and even the geographical environment. For example, banks often operate with high leverage (a large proportion of debt) because their business model is based on managing borrowed funds. Meanwhile, retail companies may more often choose a more conservative structure because their income is less constant. As the Corporate Finance Institute (2025) notes, companies need to constantly assess the balance of debt and equity in order to maintain flexibility and be able to adapt to changing market conditions.

It is also important to mention that the choice of capital structure has a direct impact on the company’s financial indicators, such as profitability, liquidity and investor confidence. Excessive leverage can increase profitability during periods of growth but also increases risk during economic downturns. Therefore, the search for the optimal capital structure is an ongoing process in which it is important to evaluate not only financial but also strategic aspects. As the Meta Platforms example shows, even with a large cash reserve, a company may choose to borrow if it helps to more efficiently finance strategic initiatives, such as investments in artificial intelligence (Gratton, 2025).

According to Rasyid (2015), capital structure can be defined in another way: "Capital structure is the choice of financing between debt and equity. Capital structure can be defined as the composition of a company's capital, which is assessed according to its specific sources, showing the share of the company's capital coming from debt sources (creditors), and at the same time showing the share of capital coming from the owners of the capital itself. Capital structure has a significant impact on achieving the company's goals - to maximize the return on investment, while minimizing risk, in order to achieve the highest return, which also requires the highest profit." Thus, according to Rasyid (2015), the definition of a company's

capital, it can be stated that to achieve the highest profit, costs must be minimal, including the cost of capital or the cost of capital, therefore the company must seek effective financing alternatives to achieve the above-mentioned company goals.

To explain the relationship between capital structure decisions and the company's performance and value, different theories of capital structure are widely discussed in the literature.

Said (2025) discusses four theories of capital structure. One of them is the Modigliani and Miller theory, or M&M theory. As I mentioned earlier, Modigliani and Miller (1958) were the first to raise the question of whether a firm's financing decisions affect its value. They argued that under ideal conditions—in the absence of taxes, bankruptcy costs, or information asymmetries—a firm's value does not depend on how it allocates its capital between equity and debt. In other words, capital structure has no effect on the market value of a firm because investors can adjust their preferred leverage. This approach, known as the "irrelevance theorem," has become a cornerstone of modern financial theory.

However, Modigliani and Miller later, in 1963, refined their theory to include the effect of taxes. They recognized that in the real world, interest expense is deductible from taxable income, so using debt can reduce a firm's tax burden. In this context, they concluded that higher leverage can increase firm value because the tax shield provides additional benefits. Therefore, in theory, firms should use as much debt as possible to maximize this effect (Said, 2025).

However, in practice there are limits. While debt can increase shareholder returns, it also increases financial risk and the likelihood of bankruptcy. Therefore, later theories, such as the trade-off theory, suggest that firms should seek an optimal balance between debt and equity, taking into account tax benefits and potential financial costs. The theories of Modigliani and Miller remain important as a theoretical framework, but in the real world, capital structure decisions are much more complex and depend on many factors (Said, 2025).

Another theory under consideration is Agency Theory. This theory examines conflicts of interest that may arise between managers (agents) and shareholders (subordinates) of a company, when managers, having decision-making power, may act in their own interests, rather than in the interests of shareholders. This theory assumes that both parties are rational and seek to maximize their own benefits, but can also act opportunistically. Agency relationships are defined as a contract under which the agent acts on behalf of the subordinate, making decisions that may affect the value of the company. One way to reduce these conflicts is to properly form a capital structure - in particular, the use of debt. Debt acts as a disciplinary mechanism, because regular interest payments reduce the free cash flow that managers could use at their discretion, thereby reducing agency costs. In this way, the inclusion of debt in the capital structure not only helps to align the interests of managers and shareholders, but can also increase the value of the company, and is therefore considered an important factor in forming an effective financing strategy (Said, 2025).

Another theory is the Trade-Off Theory. The trade-off theory states that firms should seek to balance the benefits and costs of debt and equity financing in order to achieve an optimal capital structure even in the presence of market imperfections such as taxes, bankruptcy risk, or agency costs. This theory assumes that each source of financing has its own specific costs and returns, which depend on the profitability of the firm, the nature of its activities, and the level of risk. Therefore, firms usually determine a target debt-equity ratio that is considered optimal for their specific conditions and strive to maintain it. However, the static trade-off model does not take into account such changing factors as adjustment costs, market expectations, or economic uncertainty, and therefore the dynamic trade-off theory is increasingly emphasized in the contemporary literature. This theory recognizes that a firm's capital structure is constantly changing and often deviates from the optimal level due to market frictions or adjustment costs, but over time, firms strive to return to their target capital structure ratio. This approach allows for a more flexible assessment of capital structure formation in real conditions and better reflects the behaviour of companies in a changing financial environment (Said, 2025).

Said (2025) discussed the Pecking order theory. This theory, developed by Myers and Majluf (1984), states that companies prefer internal financing and choose external financing only when internal funds are insufficient. This theory is based on the assumption of information asymmetry between managers and investors - managers have more information about the true state of the company, so external financing may be more expensive due to risk perception. Financing sources are arranged hierarchically: internal funds are used first, then short-term debt, then long-term debt, and equity is considered a last resort. Profitable companies that generate sufficient cash flows tend to avoid borrowing and finance investments from retained earnings, which is why their debt level is lower. Although the theory does not contradict factors such as tax breaks or debt restrictions, it emphasizes that the order in which financing sources are chosen is the most important factor in shaping the capital structure.

3. Content analysis

Demiraj et al. (2025) conducted a large-scale study covering more than 3,000 European companies and found that there is an inverted U-shaped relationship between capital structure (debt level) and the company’s financial performance (ROE). This means that both too low and too high debt levels can be harmful. The study found that the optimal capital structure for all companies is about 29% debt, but as I mentioned earlier, this indicator varies across sectors: for example, in the manufacturing sector – 21%, real estate – 28%, wholesale – 41%. Thus, this study reveals that the optimal debt level depends on the nature of the activity and its capital intensity.

Meanwhile, Said (2025)’s study in Egypt showed that short-term debt has a positive effect on the market value of the firm (Tobin’s Q), but long-term debt and the total debt-to-equity ratio (DE) often have a negative effect on ROA and TQ.

Interestingly, the DE ratio has a positive effect on ROA but a negative effect on ROE. These results suggest that the impact of capital structure depends on the chosen performance indicator and also confirm the applicability of pecking order and trade-off theories in different contexts.

In summary, capital structure is not static – it is a dynamic set of decisions that must be constantly reviewed considering the company's strategy, market conditions and financial goals. The optimal debt-equity ratio allows a company to achieve better operating results, reduce risk and increase shareholder value. Research shows that an average debt level is often the most effective, but each company must assess its specifics and choose a structure that best meets its long-term goals.

When analysing the impact of a company's sustainability activities on its capital structure, it can be noted that most of the research in the 2020-2025 was conducted through the prism of ESG criteria. It is in this context that I would like to recommend several studies that have been conducted, what methods were used, in what area the research was conducted and summarize the results obtained. According to the studies presented in Table 1, most of them assess the impact of ESG on capital structure, especially on debt level and cost of capital, and also generally find a negative relationship between ESG and financial leverage, and summarize how ESG works through information transparency, reputation and investor trust.

ESG disclosure refers to the provision of non-financial information about a company's environmental, social and governance practices that enable investors to better assess the sustainability and risk profile of an organization (Amel-Zadeh & Serafeim, 2018). The importance of this information has increased in recent years for several reasons. Eccles et al. (2014) note that investors increasingly view ESG data as a signal of a company's governance effectiveness and ability to manage long-term risks. In addition, regulatory pressure is increasing, especially in the European Union, where the Sustainable Finance Disclosure Regulation (SFDR) obliges financial market participants to publicly disclose information related to sustainability aspects.

According to the research analysis conducted by Tawfiq et al. (2024), those scientific works that highlight more complex, context-specific relationships are also considered. For example, Bae et al. (2021) found that the relationship between ESG and financial leverage is nonlinear and depends on the country's legal system and level of financial development, while Nguyen et al. (2020) provided evidence of an inverted U-shaped relationship, where companies with an average ESG score are characterized by higher financial leverage. These results suggest that the impact of ESG on capital structure may vary depending on the company's environment, sector or geographical context, therefore it is necessary to consider a wider range of institutional and economic factors when assessing the significance of ESG for companies' financial decision-making (Tawfiq et. al., 2024).

Tawfiq et al. (2024) themselves, the purpose of the study was to assess how ESG indicators affect the capital structure and weighted average cost of capital (WACC) in large non-financial US companies. The selected sample consisted of 25 Fortune 500 companies, for the period from 2007 to 2022. The study used a dynamic panel regression model using the generalized method of moments (GMM), which helps to

overcome the endogeneity problem. The dependent variables were the leverage ratio and WACC of the companies, and the main independent variable was the total ESG disclosure score and separate components: environment, social aspects and governance factors. Control variables included profitability, company size, Tobin's Q, liquidity ratios, etc.

Table 1
Studies have been conducted on the impact of corporate sustainability activities on capital structure

Reference	Methods	Subject	Region	Key variables	Results
Newton et al. (2024)	IV regression	USA firms	USA	ESG reputational risk, bank loan structure	High ESG reputational risk reduces reliance on term loans and encourages public lending
Hou & Zhang (2024)	Panel regression	Chinese firms by CSI ESG	China	CSI ESG score, debt financing costs	Higher ESG score correlates with lower borrowing costs; the largest effect is on governance components
Yang et al. (2024)	Panel Regression	Chinese Listed Companies	China	ESG Score, Excess Debt	ESG significantly seduces excess debt Level
Yao (2025)	Panel Regression with Greenwashing Index	Chinese Listed Companies	China	ESG Disclosure Quality (greenwashing), cost of debt	False ESG disclosure strategies (greenwashing) reduces cost of debt in the short run
Tawfiq et al. (2024)	Generalized Method of Moments (GMM)	25 „Fortune 500" companies	USA	ESG scores, leverage, WACC, profitability, company size	Higher ESG disclosure levels are associated with lower leverage and WACC

Source: designed by the author.

The results revealed a significant negative relationship between ESG disclosure and both of the analysis indicators – leverage and cost of capital. Companies that are more active in disclosing ESG information tend to have lower debt levels and lower capital costs, which is interpreted as a signal of better reputation and lower risk to investors. In addition, it was found that environmental and social aspects have a stronger influence than governance factors. The study also revealed a nonlinear (U and inverted U-shaped) relationship between ESG and financial indicators and showed that this relationship is stronger among larger companies that have more resources for ESG activities. These results emphasize the importance of ESG information not only as a part of social responsibility, but also as part of financial strategy (Tawfiq et al., 2024).

Thus, sustainability activities reduce corporate risk, especially related to regulatory requirements, reputational incidents and environmental disasters. This leads to greater confidence of creditors and investors, and at the same time, a lower required risk premium for debt or equity. It is important to note that companies with high ESG performance are more likely to raise long-term debt capital, using special financing instruments that offer more favourable terms than traditional debt instruments (Fatemi et al., 2015). It should also be emphasized that the impact of sustainability activities on the capital structure is not the same across industries. As Khan et al. (2016) point out, the materiality of ESG issues – that is, their importance in a particular industry – determines the extent to which sustainability factors affect financial conditions. Research shows that ESG/CSR activities can be considered a strategic factor in the financial structure, and its impact depends on the context: sector, region, quality of ESG implementation, and assessment tools.

4. Conclusion

Corporate sustainability activities are becoming one of the most important factors in shaping the modern capital structure. Disclosure of ESG information and a responsible approach to environmental, social and governance aspects lead to a lower cost of capital, better investor confidence and more favourable financing conditions. Empirical research confirms that a high level of sustainability activities is usually associated with lower financial leverage and greater company stability. Sustainability activities also act as a reputation and risk management mechanism and therefore can be considered a strategy for long-term value creation. Thus, integrating sustainability into financial decisions is an important aspect to ensure the competitiveness of companies and the sustainability of capital markets.

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