

DO FIRMS WITH HIGHER AGENCY COSTS USE ESG DISCLOSURES AS A LEGITIMACY TOOL?

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Wajid Alim**Abstract**

The purpose of this study is to explore whether firms use environmental, social, and governance disclosures to gain organizational legitimacy when agency costs increase. Agency theory suggests that the disclosure of ESG information reduces information asymmetry, monitoring costs, and conflicts between managers and capital providers. An alternative is legitimacy theory, which posits that managers might make disclosures that are more visible but do not correct governance gaps or bad decisions. The analysis uses descriptive statistics, correlations, multicollinearity diagnostics, pooled least squares, and fixed-effects estimation and is based on 6,190 firm-year observations. The Hausman test provides backing for fixed effects; namely, that unobserved firm characteristics are correlated with the explanatory variables included in the model. In the fixed-effects regression (FE) model, the coefficient on ESG disclosure is positive but significant only at the 10 percent level. This is a weak positive correlation, indicating that unresolved agency costs in firms can co-occur with ESG reporting. Assurance, controversies, disclosure quality, and managerial intent are still unobserved; however, this provides no evidence of legitimacy management. Agency costs appear to have a strong negative relationship with profitability, and neither audit fees nor firm size have a statistically meaningful relationship with profitability. The study combines agency and legitimacy theories, distinguishes between statutory and symbolic disclosure, and offers implications for boards, investors, and regulators. Future studies should work in reverse, testing whether agency costs predict ESG disclosure.

INTRODUCTION

Environmental, Social, and Governance disclosure has gone from a voluntary corporate communication to an important part of accountability systems today. Investors are increasingly incorporating ESG information into risk and resilience assessments, managerial quality, and future corporate cash flows (Christine et al., 2025). Regulators also encourage similar

sustainability reporting, as traditional statements lack more detailed descriptions of environmental exposure, workforce practices, and governance mechanisms. But greater disclosure doesn't necessarily imply increased accountability, more for the shareholder, or less friction between shareholders and managers. ESG narratives can be effective in communicating genuine change by managers, but they can also shield a company's

reputation when there is a dispute within an organization (Wang et al., 2025). This ambiguity raises an important research question: whether firms with higher agency costs employ ESG disclosure for legitimacy purposes. ESG reporting can help lower these costs by increasing information, enhancing stakeholder oversight, and subjecting stakeholders to external review. From that perspective, ESG communication serves as a legitimacy tool to shape stakeholders' perceptions, but it does not address governance shortcomings (Khamisu & Paluri, 2024). This disclosure can thus be of a service to informational accountability purposes, to symbolic protection purposes, or to some combination of the two organizational purposes.

The objective of this study is to examine whether ESG disclosure is associated with agency costs and potentially supports organizational legitimacy. The paper also determines whether the ESG relationship remains after controlling for profitability, firm size, audit fees, and firm-specific effects. Moreover, the work also contributes to assessing whether the findings support substantive monitoring, legitimacy management, or a cautious combination of both explanations.

The study examined the 6190 firm-year observations and conducted descriptive statistics, correlations, variance inflation factors, pooled regression, and fixed-effects estimation. The data included in this problem statement are as follows: Agency Cost, ESG Disclosure, Firm Size, Logged Audit Fees, and Return on Equity. Due to the lack of country-level data and reporting periods, the paper does not make any unfounded assertions regarding specific institutions, regulations, or market conditions. An important distinction between the tested association and the proposed direction is that the empirical model treats agency cost as the dependent variable. The rest of the sections present theory, review empirical literature, discuss methodology, present results, discuss implications, and identify future research priorities.

2. Literature Review and Hypotheses Development

According to Jensen & Meckling (1976), an agency relationship exists when the principal entrusts decision-making power to an agent with different incentives. Information asymmetry makes it difficult for principals to monitor managerial actions, thereby increasing monitoring costs and creating more opportunities for managerial self-interest. Segrestin et al. (2019) also argue that the separation of decision management and decision control demands good governance and good information systems. These systems can be strengthened by disclosing policies, targets, risks, performance indicators, and the Board's role in overseeing ESG disclosure. Detailed disclosure can provide an excellent tool for shareholders to see how managerial pledges can help create long-term value, and to question the actions and decisions that lead to its destruction. Consequently, credible ESG communication can be a structuring device that reduces uncertainty and could help to curb opportunistic managerial actions.

Evidence has previously linked higher sustainability disclosure to better information environments, and possibly positive capital market outcomes for the reporting firm. Bose et al. (2017) link voluntary nonfinancial disclosure to financing benefits but suggest that institutional conditions affect the economic consequences. Marshall et al. (2009) demonstrate that the dimensions of environmental disclosure quality vary in the effects on the market. Fatemi, Glaum, and Kaiser (2018) report that ESG disclosure moderates the influence of ESG strengths and concerns on firm valuation. Eliwa, Aboud, and Saleh (2021) show that the institutional framework in Europe influences debt financing through stronger ESG practices. Together, these results validate an accountability interpretation that credible reporting diminishes information risk and augments external monitoring (Amel-Zadeh & Serafeim, 2017).

Agency theory also suggests that managers will take advantage of opportunities to engage in discretionary reporting when verification is not feasible and/or enforcement is lax. Managers can

choose to report convenient indicators, focus on distant indicators, ignore negative boundaries, or tell stories without reference to operational investment (Menkes et al., 2024). Kim, Park & Wier (2011) link stronger social responsibility to reporting, but this is only possible if there is consensus for it on the organizational level. The ESG ratings vary significantly due to measurement divergence between apparently similar ratings. Christensen, Hail & Leuz (2021) describe how sustainability reporting requirements can entail benefits, costs, and implementation challenges. Hence, along with increased quantity, the level of comparability and verification, and the usefulness for decision-making may also decline, so the agency problem is not necessarily mitigated when disclosure is expanded.

The legitimization theory seeks to account for disclosure by focusing on the relationship between organizational actions and society's changing norms and expectations. Suchman (1995) recognizes pragmatic, moral, and cognitive legitimacy, all of which rely on different relationships between organizations and social audiences. Additionally, Deegan (2002) states that if the public is concerned, social and environmental disclosures can help restore, repair, or build legitimacy for the organization. Cho and Patten (2007) find that environmental disclosure patterns support legitimacy responses among firms with comparatively weak environmental performance. Patten (1992) also shows that corporate disclosure can shift following significant events that threaten an industry or organization's legitimacy. These studies provide evidence that disclosure intensity increases with perceived scrutiny, criticism, and reputational vulnerability. When communication is used to replace material change, legitimacy strategies can be problematic, as

stakeholders can be reassured by a narrative without improvement, or even by a worsening one. Cho et al. (2015) capture the tensions of sustainability reporting by using the concept of organized hypocrisy; a situation in which there is a mismatch between the words, decisions and actions of corporations. Michelon, Pilonato and Ricceri (2015) provide evidence that reporting practices and assurance do not necessarily lead to better disclosure quality. Hummel and Schlick (2016) categorize reasons for sustainability disclosure according to the economic and organizational-behaviour perspectives on legitimacy. More recently, Deegan (2019) warns researchers about the dangers of using legitimacy theory unqualifiedly, without articulating the audience, the threat, the response, and the consequences for the organization. Thus, it is a mistake to conclude that all positive disclosure associations are greenwashing without investigating reporting quality and performance alignment.

The two theoretical roles of disclosure and agency costs, as observed in firm-year data, are jointly predicted. A monitoring explanation holds that greater disclosure will lead to greater transparency and, over time, to reduced agency costs. A legitimacy explanation predicts that companies with unresolved agency conflicts will be more likely to enhance disclosure to ensure acceptance by influential stakeholders (Hussain et al., 2025). The second forecast identifies a positive relationship between communication and internal control issues; they both go in the same direction.

H1: ESG disclosure is significantly associated with agency costs after controlling for profitability, firm size, audit fees, and firm-specific effects.

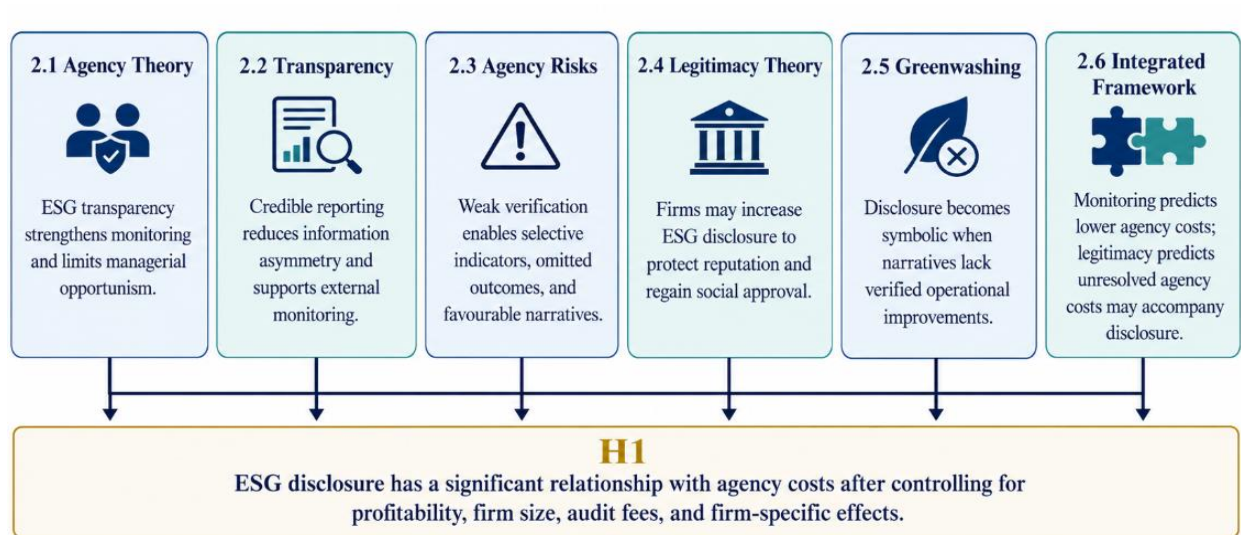


Figure 1: Theoretical Frameworks.

Research Methodology

Research Design, Data Structure, and Sample

The analysis is based on 6,190 firm-year observations, forming a large firm-year panel for analyzing intra-firm heterogeneity across repeated reporting periods. Countries, exchanges, industries, observation years, sampling screens, and number of unique firms are not identified in the source file. Hence, in this paper, only confirmed characteristics of the data sets are reported, and no fictional information about institutions is introduced, which might be misleading for future readers. Before journal submission, authors should provide data sources, coverage years, exclusion criteria, financial-sector treatment, and missing-value procedures. They also should describe whether the panel is balanced and how mergers, delistings, currency differences, and outliers were addressed. These additions are necessary because the sample's construction affects external validity, the repeatability of estimated relationships between firms, and the interpretation of those relationships.

Variable Measurement and Operationalization

In the regression models provided for agency cost, the dependent variable is AC. The mean is 0.710, the standard deviation is 1.765, and the range is between -137.494 and 1.630. The negative minimum is extremely low, indicative of a ratio-

based proxy, an unusual denominator, a data error, or an economically exceptional observation. Before submitting to the journal, researchers should discover the exact formula and check for winsorisation, robust estimation, transformation, and influence diagnostics. The average ESG disclosure score is 38.642, with a wide range of 0.735 to 87.876 across the entire analytical sample. This dispersion helps identify variation but requires documentation of the index provider, pillar coverage, scoring direction, and missing-data handling.

Statistical Analysis and Model Selection

Empirical analysis begins with descriptive statistics and Pearson correlations, followed by variance inflation factor testing to assess harmful multicollinearity. Pooled ordinary least squares estimate give an initial association, assuming that the observations were not worth discriminating. Persistent attributes are typically found in panel firms, such as managerial culture, ownership composition, risk appetite, industry position, and reporting practices (Gold et al., 2022). Fixed effects eliminate the effect of firm-specific factors that do not vary over time and estimate relationships by including within-organization changes. At the conventional 5% significance level, the Hausman test reported a probability of 0.0484, strongly favouring fixed effects. Hence,

fixed-effects estimates receive particular attention, as unobserved firm characteristics are likely to be correlated with the included explanatory variables.

Econometric Model Specification

The specification is estimated to be a set of parameters α_i , β_1 , β_2 , β_3 , β_4 and the error term ϵ_{it} , where $AC_{it} = \alpha_i + \beta_1 ESG_{it} + \beta_2 SIZE_{it} + \beta_3 LNAF_{it} + \beta_4 ROE_{it} + \epsilon_{it}$. In this case, α_i denotes time-invariant firm effects, and ϵ_{it} denotes other firm-year effects that are not accounted for by the variables included. Year effects, industry effects, clustered standard errors, heteroscedasticity tests, and serial-correlation diagnostics are not reported with the provided output. A more robust publication model would incorporate year indicators and standard errors grouped to reflect repeated-observation dependence of the firm (Bagh et al., 2025). Cross-sectional dependence, nonlinearity in the data, dynamic persistence, and even endogenous ESG reporting decisions should be assessed by researchers. These checks would assess the consistency of the reported marginal ESG

association under more stringent empirical assumptions.

Directionality, Endogeneity, and Robustness Requirements

Directional mismatch is not resolved between the research question and the supplied regression, since the problem's explanation is on the left side: AC. The question posed in the title aims to investigate whether agency costs drive ESG disclosure, necessitating the measurement of ESG disclosure as the dependent variable in an empirical investigation. Hence, a complementary specification should include lagged agency costs, controls, firm effects, and year effects in estimating ESG_{it} . The use of lagged agency costs would also help to better order the data over time, but instrumental variables or dynamic panel methods might still be needed. Extended models should include disclosure quality, negative controversies, emissions performance, ownership concentration, board independence, external assurance, and institutional pressure. This paper will use the provided specification, but the conclusions will be limited to conditional association and not directional behaviour.

Table 1: Variable Summary.

Variable	Role in Model	Interpretive Function
AC	Dependent variable	Proxy for managerial-stakeholder conflict
ESG	Independent variable	Scope or extent of reported ESG information
Size	Control variable	Scale, visibility, and reporting capacity
LNAF	Control variable	Complexity and external monitoring intensity
ROE	Control variable	Accounting profitability

Results and Discussion

Table 2: Descriptive Statistics.

Variable	Obs	Mean	Std. dev	Minimum	Maximum
AC	6,190	0.7101	1.7655	-137.4937	1.6302
ESG	6,190	38.6423	16.3779	0.7345	87.8757
Size	6,190	22.1086	1.2978	18.7061	26.9816
LNAF	6,190	12.7423	0.8297	9.8349	19.4842
ROE	6,190	0.1127	0.1275	-3.3578	1.4669

The agency cost is highly skewed around the mean, as indicated by descriptive evidence, largely due to the low minimum value. However, ESG disclosure also shows significant diversity, with some

companies appearing to provide lower-scope, lower-performance coverage, or lower index assessments. Return on equity shows notable downside dispersion, which can be due to loss-

making companies, small equity denominators, or exceptional restructuring periods. For these distributions, the coefficient estimates, standard

errors, and model comparisons are likely to be significantly affected by extreme observations; hence, strong outlier analysis is warranted.

Table 3: Correlations and Multicollinearity

<i>Variable</i>	<i>AC</i>	<i>ESG</i>	<i>Size</i>	<i>LNAF</i>	<i>ROE</i>
AC	1.0000				
ESG	0.0185	1.0000			
Size	0.0171	0.2876*	1.0000		
LNAF	0.0151	0.2727*	0.7117*	1.0000	
ROE	-0.0428*	-0.0233	-0.1208*	-0.0981*	1.0000

Table 4: Variance Inflation Factors and Tolerance Statistics.

<i>Variable</i>	<i>VIF</i>	<i>Tolerance (1/VIF)</i>
Size	2.08	0.481441
LNAF	2.05	0.488319
ESG	1.10	0.907743
ROE	1.02	0.984926
Mean VIF	1.56	—

The correlation coefficient between ESG disclosure and agency cost is 0.0185, indicating a very low positive unconditional relationship between the two. Firm size (+0.2876) and logged audit fees (+0.2727) are positively and statistically significantly correlated with ESG disclosure. The correlation between firm size and Ln (Audit fees) is high (0.7117), with larger firms having greater complexity and, hence, higher audit fees. The

mean value of VIF is 1.56, and the largest are size at 2.08 and audit fees at 2.05. They both have tolerance values above the common 0.10 warning threshold and comfortably above 0.481441 and 0.488319. The ESG and profitability have ESVs of 1.10 and 1.02, respectively, indicating that multicollinearity is not a problem for interpreting the coefficients.

4.3 Model Selection and Diagnostics

Table 5: Reported Model-Selection and Diagnostic Statistics.

<i>Test or statistic</i>	<i>Reported value</i>	<i>Decision or interpretation</i>
Pooled model F probability	Prob > F = 0.0088	Regressors are jointly significant
Pooled model sum of squares	42.3090459 (df = 4)	Model mean square = 10.5772615
Hausman test	χ^2 (2) = 1.45; p = 0.0484	Prefer fixed effects at 5%
Fixed-effects model	F (2, 6178) = 7.27; p = 0.0007	Reported model is jointly significant
Firm-effect correlation	Corr (u _i , X _b) = -0.0902	Firm effects correlate negatively with fitted index

The pooled model is jointly significant at p = 0.0088; the fixed-effects model is still jointly significant at p = 0.0007. The Hausman probability of 0.0484 suggests that the assumption of random-effects consistency is rejected at the 5% level, and the fixed-effects estimation is

considered. Another sign of a negative firm-effect correlation is the high number of persistent organizational characteristics that migrate in the opposite direction from the fitted explanatory index. Nevertheless, the findings from the fixed-effects model constitute the main framework for

these results, with the absence of year effects and clustered errors being limitations.

Table 6: Complete Pooled OLS Estimates.

<i>Variable</i>	<i>Coeff</i>	<i>Std. error</i>	<i>t</i>	<i>p-value</i>	<i>95% CI lower</i>	<i>95% CI upper</i>
ESG	0.0016351	0.0014371	1.14	0.255	-0.0011821	0.0044523
Size	0.0076212	0.0249026	0.31	0.760	-0.0411965	0.0564390
LNAF	0.0062721	0.0386764	0.16	0.871	-0.0695470	0.0820913
ROE	-0.5738832	0.1772510	-3.24	0.001	-0.9213567	-0.2264096
Constant	0.4631771	0.4084406	1.13	0.257	-0.3375085	1.2638630

The pooled model is jointly significant, with an F-test probability of 0.0088, although individual coefficients differ substantially. ESG disclosure records $\beta = 0.0016351$, $SE = 0.0014371$, $t = 1.14$, and $p = 0.255$. Its interval ranges from -0.0011821 to 0.0044523, crossing zero and confirming statistical insignificance at conventional thresholds. Size and audit fees remain insignificant because their intervals also include

zero, with p-values of 0.760 and 0.871. Profitability records $\beta = -0.5738832$, $SE = 0.1772510$, $t = -3.24$, and $p = 0.001$. It's an entirely negative interval, from -0.9213567 to -0.2264096, and provides strong evidence that profitability accompanies lower agency costs. However, pooled estimation may remain biased whenever persistent firm characteristics correlate with disclosure choices and included financial controls.

Table 7: Complete Fixed-Effects Estimates.

<i>Variable</i>	<i>Coeff</i>	<i>Std. error</i>	<i>t</i>	<i>p-value</i>	<i>95% CI lower</i>	<i>95% CI upper</i>
ESG	0.0023859	0.0014451	1.65	0.099	-0.0004469	0.0052188
ROE	-0.6091170	0.1767977	-3.45	0.001	-0.9557019	-0.2625320
Size	0.0109104	0.0251843	0.43	0.665	-0.0384596	0.0602805
LNAF	0.0022057	0.0389189	0.06	0.955	-0.0740888	0.0785003
Constant	0.6865477	0.0633095	10.84	0.000	0.5624390	0.8106565

The Hausman probability of 0.0484 rejects the null of random-effects consistency at the 5% level and supports the fixed-effects specification. Fixed-effects ESG records $\beta = 0.0023859$, $SE = 0.0014451$, $t = 1.65$, and $p = 0.099$. This is significant only at the 10 percent level but not at the 5 percent level, so it requires careful wording and circumspect conclusions. For every 1-point increase in ESG, total agency cost increases by approximately 0.0024 agency cost units, with other factors (controls) and other firm effects (time-invariant) held constant. The interval ranges from -0.0004469 to 0.0052188, crosses zero, and so has a small negative relationship that is plausible. Consequently, the absence of an association between ESG and the fixed-effects model's outcome cannot be rejected at the traditional 5% significance level.

5. Discussion

The limited support for disclosure, along with the unaddressed agency costs, is reflected in the marginal positive ESG coefficient. Managers who perceive they are at risk due to internal governance issues might seek to increase the visibility of sustainability communication to stakeholders to maintain acceptance (Abdelmoneim & Deeb, 2024). These are easier to report than measurable operational transformations and can include policies, commitments, awards, and future targets. This reading is consistent with legitimacy research, which indicates that disclosures will change when social expectations, controversy, or performance gaps threaten the organization. The estimate is indirectly consistent, though, as the model does not observe legitimacy threats nor intentional impression-management behaviour. It must therefore be considered at best suggestive evidence

that must be substantiated with disclosure-quality, controversy-related empirical tests.

At the same time, the weak outcome of the five percent is called into question by robust statements about the ability of ESG disclosure to systemically fix legitimacy or to hold managers back from opportunism. Standardized scores may remain too varied because environmental, social, and governance information is combined with varying relevance across stakeholders. Aggregate scores may be noisy substitutes for disclosure quality, as it is an important strategic issue and the sustainability material issue varies by industry. Raimo et al. (2021) show that a financially material sustainability activity can have a different meaning than an immaterial activity. Further evidence of the impact of measurement challenges the ratings of some of the parties (Berg et al., 2022). Dissecting pillars, themes and material topics, quantitative indicators, targets, controversies, and assurances might uncover more relationships embedded in the overall scores.

The strong negative coefficient on profitability suggests that the agency costs of profitable firms are lower, controlling for observable factors and firm effects. Successful operations can alleviate managerial pressures, funding limitations, suboptimal risk allocation, and disagreements over limited organizational resources. Alternatively, reduced agency costs can positively impact decision-making, leading to increased profitability and, once again, reverse causality (Anifowose, 2025). The return on equity may also be unstable if book equity is small or even negative, leading to very large positive values and/or a non-linear relationship. Profitability should be replaced by return on assets, operating margin, cash flow, and market-adjusted performance measures in robustness tests. The alternatives would provide a means of evaluating profitability as a governance relationship, rather than one maintained solely because of accounting denominators. There is a need for future analysis to differentiate among audit firm quality, audit tenure, ESG assurance, scope of assurance, and the assurance standard used (Gerged et al., 2020). These measures would be better suited to assessing whether legitimacy-

oriented communication translates into credible accountability to external actors.

6. Implications

Boards should consider ESG reporting as an integral component of governance architecture, and should not attempt to develop sustainability reports as standalone communication products. Disclosed objectives should be linked to capital allocation, executive incentives, risk management, operating duties and the independent verification of performance indicators. But audit committees should scrutinize whether metrics are applied selectively, whether changes to their boundaries are explained, whether negative impacts are not hidden, and whether there are inconsistencies between the reports and operational evidence. Investors should compare disclosure growth against controversy records, emissions trajectory, workforce outcomes, governance improvements, and external assurance statements (Khamisu & Paluri, 2024). These practices might facilitate the identification of genuine accountability, distinguishing it from legitimate communication and accountability without the necessary organizational change.

7. Conclusion, Limitations, and Future Research

This study aims to analyze whether ESG disclosure serves as a legitimacy tool for companies with above-average agency costs. The evidence is from fixed-effects analysis, which shows a positive ESG coefficient, although it is only marginally significant at the 10% level (Broadstock et al., 2021). The findings imply that disclosure can occur even when agency costs are not resolved, but not intentional legitimacy management. Profitability shows a steady decline, while firm size and reported audit fees are not statistically significant. This evidence then suggests that we should be cautious and adopt only a partial interpretation that includes agency monitoring, legitimacy pressure, measurement limitations, and potential simultaneity. Several limitations constrain the extent to which stronger conclusions can be drawn and set clear priorities for future research to be undertaken for analysis and journal submission. Firstly, the countries, industries,

years, firms, databases, and sample selection procedures should be fully reported before evaluation by external parties. Second, the exact definitions of the variables are unavailable, and an extreme negative observation in the agency-cost distribution needs to be validated. Lastly, it is not possible to determine from the aggregate ESG scores whether the observed coefficient is driven by environmental, social, or governance information.

Future research should estimate ESG disclosure using lagged agency costs, firm effects, year effects, and suitably clustered standard errors. Aggregate scores should be compared against pillar measures, material topics, textual specificity, quantitative targets, negative disclosures, and external assurance. Reporting mandates or governance shocks may offer better identification for difference-in-differences approaches than contemporaneous association models (Khatri et al., 2025). Additional methods for addressing endogeneity and selection issues include dynamic panel estimators, instrumental variables, matched samples, and sensitivity analyses. The combination of these extensions would, on the one hand, set out when ESG disclosure really promotes accountability and, on the other, when it does more to safeguard organizational legitimacy.

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