AILEGITIMACY THEORY SHAPING CORPORATE ESG PRACTICES, AND THE CHALLENGES POSED BY GREENWASHING

INTRODUCTION

Legitimacy theory plays an essential role in encouraging companies to adopt Environmental, Social, and Governance (ESG) practices by emphasizing the need for firms to align with societal norms and expectations to maintain their legitimacy. According to legitimacy theory, organizations must operate within the value systems of the societies in which they exist to be perceived as legitimate, which is essential for their continued existence and success (Lee & Raschke, 2023). As societal awareness and demand for environmentally friendly products and services grow, ESG practices have become a primary strategy for firms to secure legitimacy (Lee & Raschke, 2023). This theory suggests that companies are not only responsible for creating shareholder value but also for caring for the environment, employees, and corporate governance, which are integral components of ESG (Lee & Raschke, 2023). The adoption of ESG practices is further driven by normative isomorphic pressures within networks, where firms are compelled to conform to the demands of social movements to maintain legitimacy, especially in densely connected networks (Tian et al., 2021).

Additionally, legitimacy theory underlines the importance of stakeholder satisfaction with firm culture, diversity, and management practices, which are foundational for stakeholder ESG legitimacy and, consequently, firm financial performance (Lee & Raschke, 2023). The theory also highlights how firms use ESG disclosures and sustainability reports to gain and secure legitimacy, as these practices create an affinity with customers and positively impact firm performance (Lee & Raschke, 2023). Furthermore, legitimacy theory is linked to corporate social responsibility (CSR), where firms adopt socially responsible behaviours to gain legitimacy, especially in contexts where there is little stakeholder pressure to do so (Al-Mamun & Zaman, 2023). This adoption is often influenced by the need to maintain a positive corporate reputation, which is closely tied to legitimacy and is shaped by stakeholders' perceptions and the socio-cultural context (Soleimani et al., 2014). In multinational corporations, legitimacy strategies are developed to address both internal and external audiences, ensuring that the firm is perceived as legitimate across different contexts and cultures (Minefee & Bucheli, 2021). Overall, legitimacy theory provides a framework for understanding why companies adopt ESG practices, as it emphasizes the alignment of corporate actions with societal values and expectations to maintain legitimacy and ensure long-term success.

The research question of the study is “How does legitimacy theory drive the adoption of ESG practices, and what are the implications of greenwashing for corporate reputation and financial performance”? Consequentially, this essay aims to explore how legitimacy theory influences the adoption of Environmental, Social, and Governance (ESG) practices by companies, the impact of these practices on corporate reputation and market value, and the challenges posed by greenwashing. It examines how firms use ESG disclosures to maintain legitimacy and discusses the role of transparency, digital transformation, and regulatory frameworks in mitigating greenwashing.

RATIONALE AND DISCUSSION

The adoption of ESG practices has a significant impact on a company's market value and financial performance. ESG performance is considered a strategic investment that enhances a firm's reputation, an intangible asset that can lead to improved financial outcomes. By providing ESG information and communications, such as sustainability reports, firms can legitimize their ESG conduct, which is positively correlated with better financial performance measures like increased revenue, reduced costs, and enhanced profits, ultimately boosting market valuation (Lee & Raschke, 2023). Furthermore, ESG performance is linked to a reduction in greenwashing, which is often associated with negative financial outcomes. Firms that engage in greenwashing may face decreased investment intentions and lower brand credibility, which can adversely affect their financial performance (Lee & Raschke, 2023). Additionally, the integration of ESG practices aligns corporate values with societal expectations, fostering legitimacy and potentially enhancing corporate reputation. This alignment can be particularly beneficial in countries where shareholder rights are prioritized, as it influences public perceptions and can lead to a more favourable market valuation (Soleimani et al., 2014). The adoption of ESG practices also addresses the growing normative pressures for firms to act responsibly, which can further enhance corporate reputation and financial performance by meeting diverse stakeholder expectations (Soleimani et al., 2014). Overall, the strategic implementation of ESG practices not only supports a company's market value by enhancing its reputation and legitimacy but also contributes to improved financial performance by aligning with stakeholder expectations and reducing the risks associated with greenwashing.

Companies leverage ESG (Environmental, Social, and Governance) disclosures to enhance their legitimacy with stakeholders by aligning their operations with societal expectations and demonstrating transparency and accountability. This approach is rooted in several organizational theories, including legitimacy theory, which posits that companies must operate in ways accepted by society to maintain their social license to operate. By disclosing ESG information, companies legitimize their actions, ensuring their continued existence and reducing the risk of societal penalties for negligence or reluctance towards ESG activities (Chong & Loh, 2023). Stakeholder theory further supports this by emphasizing the importance of considering the interests of various societal members connected to business activities, such as employees, customers, and communities. Engaging in ESG practices can enhance shareholder value by improving a company's reputation, attracting more customers, and minimizing regulatory costs (Chong & Loh, 2023).

As well, ESG transparency serves as a signal to external stakeholders of a firm's credibility and commitment to sustainability, thereby reducing information asymmetry and agency costs, which can influence the firm's risk profile and valuation (Chong & Loh, 2023). Companies that effectively disclose ESG information can protect their reputation and shareholder value, even when financial performance is suboptimal, as stakeholders perceive them as more transparent and accountable (Ismail et al., 2019). Moreover, ESG disclosures can help companies avoid legal concerns, such as lawsuits or penalties, by demonstrating compliance with ethical and environmental standards (Ismail et al., 2019). The integration of ESG strategies into corporate conduct, particularly in environmental, social, and governance components, is essential for legitimizing these strategies and enhancing firm financial performance through improved ESG scores (Lee & Raschke, 2023). Overall, ESG disclosures are a strategic tool for companies to build trust and legitimacy with stakeholders, ensuring long-term sustainability and competitive advantage in the market.

Improved ESG scores significantly influence investor perceptions and decision-making by enhancing a firm's attractiveness to investors with longer investment horizons. Investors increasingly use ESG scores as a measure of a company's commitment to sustainable practices, which can lead to a preference for firms with higher ESG scores (Liu & Zhang, 2023). This preference is driven by the perception that companies with strong ESG performance are better positioned for long-term success and are less likely to engage in unethical practices, such as fraud (Liu & Zhang, 2023). Additionally, ESG transparency and disclosure are important for investors, as they provide insights into a company's ethical and sustainable business practices, which are increasingly important in investment decisions (Ismail et al., 2019). Companies that disclose comprehensive ESG information tend to have lower capital costs, as transparency reduces perceived risks and enhances investor confidence (Ismail et al., 2019). Furthermore, ESG scores are linked to a firm's innovation capacity, with higher scores indicating a greater ability to innovate, which is an attractive trait for investors seeking growth opportunities (Broadstock et al., 2020).

However, the relationship between ESG transparency and financial indicators, such as firm valuation, can be complex, with some studies indicating a negative relationship, particularly in sectors like palm oil, where larger firms face more scrutiny (Chong & Loh, 2023). Despite this, the overall trend suggests that improved ESG scores positively impact investor perceptions by aligning with the growing demand for sustainable and ethical investment options. This alignment is further supported by the evolving market dynamics, where investors are increasingly considering the broader social and environmental impacts of their portfolios, beyond just financial returns (Eccles et al., 2020). As such, companies with higher ESG scores are perceived as more responsible and forward-thinking, which can enhance their reputation and attract a broader base of investors committed to sustainable investing (Eccles et al., 2020). In summary, improved ESG scores play a central role in shaping investor perceptions and decision-making by signalling a company's commitment to sustainability, reducing perceived risks, and aligning with the ethical values of modern investors.

Environmental, Social, and Governance (ESG) performance significantly influences risk assessment, access to capital, and long-term shareholder returns. ESG performance enhances stock liquidity, attracts institutional investors, and reduces financial distress, thereby impacting these financial aspects positively. Table 1 explore these influences in detail.

Table 1: Influences of Environmental, Social, and Governance (ESG) performance

Influences of ESG Performance	*Description*
ESG Performance and Risk Assessment	ESG performance can mitigate financial distress by enhancing transparency and reducing risks associated with climate change. Companies with robust climate change disclosure performance (CCDP) experience lower financial distress, especially when they have a risk committee and employ reputable auditing firms (Alshahrani et al., 2023).
	During periods of macroeconomic uncertainty, companies with strong ESG practices are better equipped to handle risks, as they are more likely to engage in activities that reduce carbon emissions and improve social and governance standards (Alandejani & Al-Shaer, 2023).
ESG Performance and Access to Capital	ESG performance positively impacts stock liquidity, which is important for accessing capital. Companies with high ESG scores experience increased stock liquidity by reducing agency costs and improving corporate reputation, making them more attractive to investors (Chen et al., 2023).
	In the hospitality and tourism industry, firms with superior social and governance performance attract more institutional investors, particularly those focused on long-term growth. This indicates that ESG performance can enhance access to institutional equity capital (Lyssimachou & Bilinski, 2023).
ESG Performance and Long-term Shareholder Returns	By improving stock liquidity and reducing financial distress, ESG performance can contribute to better long-term shareholder returns. The increased investor confidence and reduced risk associated with strong ESG practices can lead to sustained financial performance (Alshahrani et al., 2023; Chen et al., 2023).
	Companies that effectively manage ESG factors during uncertain times are likely to maintain profitability, which is central for long-term shareholder value (Alandejani & Al-Shaer, 2023).

Source: developed by the authors

While ESG performance generally enhances financial metrics, the impact can vary across industries and regions. For instance, environmental performance may not significantly increase institutional holdings in all sectors (Lyssimachou & Bilinski, 2023). Additionally, macroeconomic factors such as political stability and cultural attitudes towards risk can influence the extent to which ESG performance affects financial outcomes (Alandejani & Al-Shaer, 2023).

Legitimacy theory provides a framework for understanding the relationship between greenwashing and corporate reputation by emphasizing the importance of aligning corporate actions with societal norms and expectations. According to legitimacy theory, organizations strive to maintain a favourable reputation by conforming their behaviour to accepted social standards, which in turn enhances their credibility and reputation (Kong et al., 2023). Greenwashing, which involves misleading stakeholders about a company's environmental practices, can undermine this alignment and thus damage corporate reputation. When firms engage in greenwashing, they risk losing legitimacy because stakeholders, including activists and evaluators, may perceive a disconnect between the company's stated environmental goals and its actual practices (Lee & Raschke, 2023). This perception can lead to a loss of trust and credibility, as stakeholders may view the company as prioritizing image over genuine environmental responsibility. Furthermore, legitimacy theory suggests that organizations earn legitimacy through institutional isomorphism, which involves conforming to prevailing norms and values to gain acceptance and trust from stakeholders (Buchanan, 2018; Deephouse & Suchman, 2008; Greenwood et al., 2017).

Greenwashing can disrupt this process by creating scepticism about the company's true intentions, thereby negatively impacting its reputation. The theory also highlights the role of stakeholder engagement in enhancing legitimacy and reputation. By constructively engaging stakeholders and transparently communicating their environmental efforts, companies can build external confidence in their intentions and activities, which is critical for maintaining a positive reputation (Hart & Milstein, 2003). However, when companies resort to greenwashing, they fail to engage stakeholders meaningfully, which can lead to reputational damage. In essence, legitimacy theory underscores the strategic importance of genuine ESG practices in building and maintaining corporate reputation, as opposed to superficial or misleading efforts like greenwashing. This alignment with societal values not only enhances legitimacy but also supports long-term financial success and stakeholder trust (Buchanan, 2018; Deephouse & Suchman, 2008; Greenwood et al., 2017; Kong et al., 2023). Therefore, companies that prioritize authentic environmental responsibility over greenwashing are more likely to sustain a positive corporate reputation and achieve legitimacy in the eyes of their stakeholders.

Firms often engage in greenwashing to maintain or enhance their legitimacy without making substantive environmental improvements. This practice involves presenting a misleading impression of a company's environmental efforts, which can be achieved through various strategies. The following sections on Table 2 explore the nature of greenwashing, with the strategies, the role of transparency and digital transformation, regulatory challenges, and Implications for Stakeholders and Policy.

Table 2:The Nature of Greenwashing

Section	*Content*
Strategies of Greenwashing	**Misleading ESG Ratings**: Companies with high ESG ratings are not necessarily reducing their carbon emissions. These firms often receive positive publicity for being environmentally friendly without making genuine efforts to improve their environmental impact. This supports the 'cheap talk' concept, where companies are not truly committed to climate action but rather focus on maintaining a favourable public image (Treepongkaruna et al., 2024).
	Deceptive Communication: Greenwashing can occur through falsification (active deceit) and information selection (passive deceit). Companies may selectively communicate positive environmental actions while omitting negative ones, creating a misleading impression of their overall environmental performance (Supriatno, 2024).
	Superficial Reporting: Firms may engage in "green talks" rather than "green actions," as seen in Vietnamese companies that disclose SDG-related information without substantial implementation. This approach helps maintain legitimacy by creating an illusion of compliance with sustainability goals (Helfaya & Bui, 2022).
	Carbon Assurance: Some firms seek higher levels of carbon assurance not necessarily to improve performance but to enhance credibility and legitimacy. This marginal improvement in carbon performance is often more about meeting stakeholder expectations than genuine environmental progress (Rohani et al., 2023).
Role of Transparency	**Information Accessibility**: Greater transparency in corporate reporting can enhance the legitimacy of green innovations. In China, firms with higher transparency, such as those audited by international firms, are perceived as more legitimate in their green innovation efforts. This suggests that transparency can mitigate greenwashing by holding firms accountable (Xia et al., 2023).
Impact of Digital Transformation	**Inhibiting Greenwashing**: Digital transformation can play a significant role in reducing greenwashing by improving information transparency and enhancing internal controls. It helps alleviate financing constraints and promotes better environmental management. However, the effectiveness of digital transformation in mitigating greenwashing varies across regions, industries, and firms (Wang et al., 2024).
Regulatory Challenges and Solutions	**Regulatory Pressures**: The introduction of environmental protection laws, such as China's Environmental Protection Law, has led to increased greenwashing among heavy-polluting firms. While these laws improve disclosure performance, they do not necessarily lead to substantive environmental improvements. Government subsidies can exacerbate greenwashing, whereas slack resources may reduce its impact (Zhang et al., 2024).
	Strategies for Oversight: To combat greenwashing, strategies such as enhancing transparency, implementing stricter guidelines for environmental claims, and promoting third-party verification are essential. These measures can help firms improve their sustainability practices and regain consumer trust (Keerthi et al., 2024).
Implications for Stakeholders and Policy	**Lack of Standardization**: The absence of universal ESG reporting standards can fuel greenwashing, as seen in the Italian poultry sector. This lack of standardization allows firms to superficially adopt sustainability practices without genuine commitment, highlighting the need for standardized reporting systems (Toscano et al., 2022).
	Barriers for SMEs: Smaller firms often face barriers such as lack of capital, which can hinder genuine green practice adoption. However, the drive for a better public image can lead to superficial greenwashing efforts instead of substantive environmental improvements (Purwandani & Michaud, 2021).

Source: developed by the authors

While greenwashing allows firms to maintain legitimacy, it poses significant challenges to genuine environmental progress, risks to long-term credibility and stakeholder trust. The role of digital transformation and regulatory frameworks is critical in addressing these challenges, but they must be effectively implemented to ensure real environmental improvements. Moreover, the development of standardized reporting and increased transparency are important in addressing these challenges and ensuring that firms make genuine environmental improvements.

CONCLUSION

This theoretical essay has explored the role of legitimacy theory in driving the adoption of Environmental, Social, and Governance (ESG) practices and the implications of greenwashing on corporate reputation and market value. The main findings highlight that companies increasingly adopt ESG practices to align with societal expectations and maintain legitimacy, which can enhance their market value and stakeholder trust. Legitimacy theory provides a framework for understanding how firms leverage ESG disclosures to gain legitimacy, often reducing the risks associated with unethical practices. Additionally, ESG transparency plays a critical role in shaping investor perceptions, fostering long-term relationships with capital markets, and mitigating greenwashing.

However, this study is not without limitations. As a theoretical essay, the lack of empirical analysis constrains the ability to generalise the conclusions across different industries and regions. Moreover, the complex interplay between ESG performance, investor perceptions, and financial outcomes requires further investigation, particularly in sectors where greenwashing may have more significant consequences. For future research, it is recommended to explore the effectiveness of regulatory frameworks in preventing greenwashing, particularly in high-risk sectors such as energy and heavy industries. Additionally, empirical studies on how digital transformation impacts transparency and reduces greenwashing across different markets would provide valuable insights. Finally, research on the development of universal ESG reporting standards and their implications for corporate accountability could address the challenges posed by the lack of standardisation in ESG disclosures.

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