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ESG DISCLOSURE QUALITY AND COST OF CAPITAL IN EMERGING ECONOMIES

The Mediating Role of Financial Reporting Quality and the Influence of Institutional Ownership

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1. Ibrahim Musa Abdulrahman
Department of Accounting, Ahmadu Bello University, Zaria, Kaduna State, Nigeria
Email: ibrahim.abdulrahman@abu.edu.ng   ORCID: 0000 0002 9001 1147

2. Naledi K. Motsepe
School of Accountancy, University of Pretoria, Pretoria, South Africa
Email: naledi.motsepe@up.ac.za   ORCID: 0000 0003 5010 2234

3. Grace Esi Owusu
Department of Accounting, University of Ghana Business School, Accra, Ghana
Email: geowusu@ug.edu.gh   ORCID: 0000 0001 6032 9908

4. Daniel Mwangi Wanjiku
Department of Finance, Strathmore University Business School, Nairobi, Kenya
Email: daniel.mwangi@strathmore.edu   ORCID: 0000 0002 1120 4456

ABSTRACT

Background: ESG disclosure quality has become a central determinant of corporate transparency, investor confidence, and market discipline in emerging economies. While firms increasingly publish sustainability and governance reports, the credibility and decision usefulness of ESG information remain contested due to greenwashing concerns, limited assurance practices, and heterogeneous institutional enforcement.

Aim: This study examined the effect of ESG disclosure quality on the cost of capital in emerging economies, while assessing the mediating role of financial reporting quality and the influence of institutional ownership in shaping disclosure credibility.

Methodology: The study employed an ex post facto design using panel data from 80 listed non financial firms across Nigeria, Ghana, South Africa, and Kenya covering 2013 to 2024. ESG disclosure quality was measured using a weighted index capturing specificity, completeness, comparability, and governance transparency. Cost of capital was operationalised using the weighted average cost of capital proxy. Financial reporting quality was measured using accrual quality and conservatism indicators, while institutional ownership was measured as institutional shareholding proportion. Data were analysed using fixed effects regression, mediation analysis, and robust regression for sensitivity checks.

Findings: ESG disclosure quality exhibited a negative and statistically significant relationship with the cost of capital, suggesting that higher quality disclosure reduces perceived risk and improves access to finance. Financial reporting quality partially mediated the relationship, indicating that ESG information becomes more decision useful when supported by credible financial reporting practices. Institutional ownership strengthened the ESG disclosure cost of capital link, implying that sophisticated investors enhance monitoring and reduce symbolic reporting incentives.

Contributions: The study extends ESG reporting literature by demonstrating that the capital market benefits of ESG disclosure depend on complementary reporting credibility and investor oversight. It provides evidence from African and emerging market contexts where disclosure quality challenges remain significant.

Recommendations
Regulators: Promote ESG reporting standards with minimum assurance requirements and industry specific disclosure metrics.
Firms: Improve ESG disclosure quality through measurable indicators and integrate ESG governance into audit and risk oversight.
Researchers: Explore dynamic effects of ESG assurance, sector specific ESG materiality, and macroeconomic risk channels in explaining financing outcomes.

Keywords: ESG disclosure quality, Cost of capital, Financial reporting quality, Institutional ownership, Emerging economies.

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1.0 INTRODUCTION

Environmental, social, and governance disclosure has become a strategic reporting instrument through which firms communicate risk management capacity, ethical posture, and long term value orientation to capital market participants. In emerging economies, ESG reporting is gaining traction due to increasing pressure from stock exchanges, regulators, civil society, and international investors. However, disclosure quality remains uneven, raising doubts about whether ESG reports truly reduce information risk or merely serve as reputational narratives.

Cost of capital represents the price firms pay to access financing and is influenced by information asymmetry and perceived risk. High quality ESG disclosure can reduce uncertainty by clarifying exposure to climate risk, labour and supply chain vulnerabilities, governance practices, and compliance readiness. Yet, the extent to which ESG reporting reduces financing costs may depend on the credibility of underlying financial reports and the monitoring strength of institutional investors.

This study therefore examines the effect of ESG disclosure quality on cost of capital within emerging economies, and tests whether financial reporting quality mediates the relationship while institutional ownership strengthens disclosure credibility.

2.0 LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Conceptual review ESG disclosure quality captures the depth, specificity, and comparability of disclosed ESG information. Cost of capital reflects the combined cost of debt and equity financing. Financial reporting quality reflects the extent to which reported earnings are reliable and free from opportunistic manipulation. Institutional ownership reflects monitoring capability due to professional investor sophistication.

Theoretical review Signalling theory predicts that high quality ESG disclosure signals superior risk management and long term orientation, reducing investor required returns. Agency theory suggests that institutional investors reduce managerial opportunism and strengthen monitoring, thereby enhancing disclosure credibility and reducing financing costs. Stakeholder theory further explains that ESG reporting builds legitimacy and reduces stakeholder conflict costs.

Empirical review Prior studies show that ESG transparency can reduce cost of capital, though outcomes vary due to weak assurance and symbolic reporting. Financial reporting quality is increasingly recognised as a credibility channel through which non financial disclosure becomes more decision useful. Institutional ownership can strengthen disclosure impacts by reducing information uncertainty and enforcing accountability.

Hypotheses H1 ESG disclosure quality significantly influences cost of capital in emerging economies. H2 Financial reporting quality mediates the ESG disclosure quality and cost of capital relationship. H3 Institutional ownership strengthens the ESG disclosure quality and cost of capital relationship.

3.0 METHODOLOGY

The study adopted an ex post facto research design using panel data from 80 listed non financial firms across Nigeria, Ghana, South Africa, and Kenya over 2013 to 2024. ESG disclosure quality was measured using a weighted index capturing specificity, completeness, and governance transparency. Cost of capital was proxied using weighted average cost of capital. Financial reporting quality was measured using accrual quality and conservatism proxies, while institutional ownership was measured as institutional shareholding proportion.

The model specification is expressed as $COC_{it} = \beta_0 + \beta_1 ESGQ_{it} + \beta_2 FRQ_{it} + \beta_3 INST_{it} + \beta_4 (ESGQ \times INST)_{it} + \beta_5 FSIZ_{it} + \beta_6 LEV_{it} + \beta_7 GROW_{it} + \varepsilon_{it}$. Mediation was assessed through sequential estimation of the ESGQ to FRQ channel and the FRQ to COC channel.

4.0 DATA ANALYSIS AND DISCUSSION OF FINDINGS

Descriptive results indicate that ESG disclosure quality varies substantially across firms and countries, reflecting differences in disclosure culture, enforcement intensity, and stakeholder monitoring. Firms with stronger institutional investor presence tend to report more specific ESG metrics, suggesting that sophisticated investors may influence reporting discipline. Correlation results reveal that ESG disclosure quality is negatively associated with cost of capital and positively associated with financial reporting quality.

Regression findings show that ESG disclosure quality significantly reduces cost of capital, indicating that improved ESG transparency lowers perceived risk and enhances financing access. Financial reporting quality partially mediates the relationship, suggesting that investors interpret ESG disclosures as more credible when financial reports are reliable and conservatively prepared. Institutional ownership strengthens the disclosure effect, implying that monitoring by professional investors discourages symbolic reporting and increases decision usefulness of ESG information.

5.0 CONCLUSION AND RECOMMENDATIONS

The study concludes that high quality ESG disclosure reduces the cost of capital in emerging economies and that part of this benefit occurs through improved financial reporting quality. Institutional ownership further strengthens the disclosure financing relationship by enhancing monitoring and credibility. These findings highlight that ESG disclosure generates stronger capital market value when integrated with credible financial reporting and active investor oversight.

Regulators should promote ESG reporting standards supported by assurance and industry specific metrics. Firms should improve disclosure depth, measurement consistency, and governance oversight for ESG risks. Researchers should investigate dynamic effects of ESG assurance and macroeconomic risk transmission channels in emerging market financing outcomes.

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