

ESG incidents and financial performance: Evidence from Korea*

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Abstract

This study investigates the impact of ESG (environmental, social, and governance) incidents on financial performance, focusing on KOSPI 200 companies from 2019 to 2023. Using ROA and ROE as proxies for profitability, we conduct panel regression analysis to control for firm-specific factors. The results show a significant negative relationship between ESG incidents and financial performance, driven primarily by governance risks. In contrast, environmental and social incidents show weaker or insignificant effects after accounting for firm fixed effects. Our findings highlight the importance of governance in shaping financial outcomes and support stakeholder theory by demonstrating the material impact of ESG risks on firm profitability.

Keywords: ESG incidents, Financial performance, ESG policy

JEL Classification: G30, G34

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1 Introduction

Recently, corporations have been encouraged to allocate more resources toward making socially responsible decisions, sparking growing interest in environmental, social, and governance (ESG) initiatives. While some CEOs actively promote ESG efforts, recognizing their importance, others argue that investing in ESG does not align with maximizing shareholder value. This debate has prompted researchers to explore the link between ESG performance and financial outcomes using diverse samples and empirical methods.

Despite numerous studies, the precise nature of the relationship between ESG and financial performance remains inconclusive. Pelozo (2009) found that while 68% of studies reported a positive relationship between ESG and financial performance, more than 30% presented negative or inconclusive findings. These mixed results indicate that outcomes depend heavily on data selection and the empirical strategies adopted.

ESG incidents refer to events where ESG-related risks materialize in reality. These incidents can manifest in various forms, such as environmental pollution, human rights violations, executive corruption, or unethical practices, which can damage a company's reputation and lead to financial losses. Managing ESG risks plays a crucial role in preventing such incidents and responding effectively when they occur, ensuring the sustainability of the business.

Recent studies have examined the relationship between ESG scores and financial performance, including in the Korean market. However, the impact of ESG incidents on financial performance has received limited attention, likely due to data constraints. Assessing ESG incidents often depends on irregular data sources, such as media coverage, which may necessitate the use of neural network models for effective analysis.

In this study, we investigate the relationship between ESG incidents and profitability in the Korean financial market using a novel data set and panel regression analysis. This methodology allows us to account for unobserved firm heterogeneity that may arise from correlations between observed and unobserved firm-specific factors. Prior research on ESG and profitability has yielded mixed results, likely due to differences in methodology. For

example, studies employing linear regression (Garcia et al., 2017; Mulyadi et al., 2010; Ningsih et al., 2022) have reported inconsistent outcomes, with some showing negative, non-significant, or varied relationships across different measures of firm value. A panel regression approach helps mitigate such inconsistencies by addressing potential endogeneity issues.

For this analysis, we collected financial data from 2019 to 2023, focusing on KOSPI 200 companies. Utilizing ESG incidents data provided by Whosgood, we used ROA and ROE as proxies for profitability to assess the relationship between ESG incidents and financial performance in Korea. Through multiple regression analysis, we identified the nature of this relationship and derived empirical results that align with our research objectives.

In this study, we collected financial data for five years, from 2019 to 2023, targeting KOSPI 200 companies to test the hypotheses. Using ESG incidents data provided by Whosgood, we employed ROA and ROE for a proxy of profitability to investigate the relationship between ESG incidents and financial performance in the Korean. Through this multiple regression analysis model, we identified the relationship between the two variables and derived empirical results aligned with the research objectives.

We present a couple of findings. Most importantly, we demonstrate a negative relationship between ESG incidents and a corporation's accounting performance. In other words, firms with higher reputational risks covered by the media tend to exhibit lower profitability. The ESG incident score shows a negative relationship with both ROA and ROE, with or without control variables. The inclusion of firm fixed effects does not alter the results, confirming the robustness of our findings.

This result aligns with the argument of Freeman (1984), which highlights the importance of stakeholders in shaping this relationship. Additionally, our findings are consistent with recent research in the Korean market (Yoon et al., 2024), which confirms a positive relationship between ESG grades and financial performance.

Furthermore, we demonstrate that governance incidents drive this negative relationship. Governance incidents consistently lead to lower financial performance; neither the choice of financial performance measure nor the inclusion of firm fixed effects alters these findings. In contrast, other incident scores—environmental and social—do not exhibit such a robust relationship. After controlling for firm fixed effects, the relationship between

environmental and social scores and financial performance becomes statistically insignificant across all models.

In particular, governance incidents encompass various critical issues, including favoritism in internal contracts, the arrest or resignation of owners, third-generation succession challenges, unethical internal transactions, CEO imprisonment and fines, and problematic practices like circular shareholding. These incidents highlight vulnerabilities in corporate governance structures and underscore the need for stronger oversight and regulatory measures.

This finding slightly diverges from the recent evidence by Yoon et al. (2024), which reports poorer financial performance for firms with lower social and environmental grades. However, the media attention surrounding governance incidents highlights their significance. Major governance issues can result in managerial and operational inefficiencies, contributing to the consistently negative relationship between governance risks and financial performance.

This work adds new dimensions to the extant literature. Most importantly, our work is the first study that examines the relationship between ESG incidents and financial performances in the Korean market. While some academic works have examined the relationship between ESG scores and financial performances, the incident score has not been examined probably due to the construction difficulties in measuring ESG incidents.

Furthermore, our work confirms the significance of stakeholder theory, which expects a positive relationship between ESG performances and financial performances. Our result confirms that this prediction is valid in a developing market, Korea and the theory applies well for the measure of ESG incident scores.

Finally, we show the significance of governance issue in driving such relationship. This seems to be rational because the governance issue is the most critical one in terms of determining operational performances. Media tends to not to cover minor governance issues and thus risky governance issues might be substantially important in shaping financial performances.

Our paper progresses as follows. We discuss the literature in Section 2. The empirical model is introduced in Section 3. The empirical analysis is conducted in Section 4. Section 5 concludes.

2 Literature Review

There have been ongoing debates about how ESG practices relate to corporate financial performance. On one hand, stakeholder theory predicts that ESG efforts positively influence financial performance (Freedman, 1984). By engaging in responsible behaviors, such as conserving energy or improving labor rights, firms can benefit from enhanced employee productivity, an expanded customer base, and an improved corporate reputation, all of which contribute to stronger financial performance.

On the other hand, the traditional view offers a contrasting perspective (e.g., Friedman, 1962; 2007). This view suggests that investing in ESG initiatives increases operational costs, conflicting with the firm's primary goal of maximizing profits, thereby implying a negative impact of ESG efforts on financial performance.

Empirical studies testing these theories present mixed findings. One stream of research focuses on the short-term financial impact of ESG practices using event study methodologies. These studies analyze abnormal returns following socially responsible or irresponsible corporate actions. For instance, Posnikoff (1997) found a positive correlation, while Wright and Ferris (1997) observed a negative one. Teoh, Welch, and Wazzan (1999) found no consistent relationship between ESG practices and corporate performance.

A second line of research examines how ESG efforts relate to long-term financial outcomes, focusing on accounting-based performance metrics. Aupperle, Carroll, and Hatfield (1985) found no statistically significant relationship between ESG initiatives and financial performance. In contrast, Waddock and Graves (1997) reported a positive relationship between ESG performance and return on assets (ROA). Similarly, McGuire, Sundgren, and Schneeweis (1997) and Waddock and Graves (1997) suggested that ESG efforts can have a more significant impact on financial outcomes in the long term. DasGupta (2021) also observed that firms experiencing financial performance shortfalls tend to improve their ESG efforts, but high levels of ESG controversies constrain these efforts. Using data from 3BL Media's "100 Best Corporate Citizens" between 2009 and 2018, Qureshi et al. (2021) confirmed a positive relationship between ESG scores and return on equity (ROE), though not consistently with other metrics such as ROA.

There are various management theories that explore the relationship between environmental, social, and governance (ESG) practices and a firm's profitability. For instance, agency theory suggests that firm managers tend to act based on self-interest and opportunistic behavior rather than prioritizing the well-being of stakeholders (Jensen & Meckling, 1976). This theory posits that principals, such as owners or stakeholders, delegate authority to firm managers, but this delegation often leads to information asymmetry, resulting in potential conflicts between the principal and the agent. In this context, if a firm manager focuses solely on maximizing the firm's value to enhance their short-term managerial reputation, it may clash with the interests of stakeholders, who often value ESG initiatives as a long-term strategy to ensure the firm's sustainability.

Several recent studies have also explored the link between ESG practices and financial outcomes across different industries. For example, Kludacz-Alessandri and Cygańska (2021) analyzed 219 firms from 32 countries in 2020, finding that companies in the energy sector implementing ESG strategies experienced significantly higher ROA and EBIT. Dalwai and Salehi (2021) examined non-financial firms listed on the Muscat Securities Market in Oman between 2015 and 2019, showing that a defender-type management strategy negatively impacted ROE. Meanwhile, Boukattaya and Omri (2021) found that ESG practices and corporate irresponsibility have opposite effects on financial performance for non-financial firms listed on France's SBF 120. Feng, Wang, and Kreuze (2017) demonstrated that ESG performance has a positive effect across most U.S. industries between 1991 and 2011, though the impact varied by sector.

Other studies highlight the importance of firm-specific factors in moderating the ESG-financial performance relationship. Rossi et al. (2021) found that board characteristics partially influence this relationship among European firms. Similarly, Nekhili, Boukadhaba, and Nagati (2020) noted that employee representation on boards affects the ESG-financial performance link in different ways.

Several studies emphasize the role of auditing in enhancing the relationship between ESG practices and financial outcomes. Moradi et al. (2022) explored how different types of intelligence—spiritual, emotional, and organizational—impact the organizational performance of auditors in Iraq, though social capital was not found to mediate these effects. Dakhli (2022) showed that firms audited by Big 4 auditors experience a stronger

positive impact of ESG practices on ROA, ROE, and Tobin's Q.

Governance also plays a critical role in shaping firm performance. Salehi and Alkhyoon (2022) analyzed firms listed on the Tehran and Iraq stock exchanges, finding that managerial entrenchment, ESG disclosure, and firm growth strategies positively influence firm performance in Iranian firms, though findings were mixed for Iraqi firms. Dalwai et al. (2021) found that governance mechanisms, such as dispersed ownership and audit committee size, improve the readability of financial reports for Omani firms in the financial sector. Additionally, Salehi et al. (2021) observed that financial leverage influences agency costs, though family ownership and state shareholders had no significant impact. Faysal et al. (2020a, 2020b) found that larger board size and longer CEO tenure reduce the cost of equity, while institutional ownership was positively related to the cost of equity for firms in Iran and Iraq.

In the literature, ESG data providers and rating agencies such as MSCI, Sustainalytics, and Bloomberg have played a central role in evaluating firms' ESG-related risks (Eccles et al., 2020). However, recent studies have revealed significant discrepancies among ESG ratings provided by different vendors (Berg et al., 2022). These ratings also vary in their ability to predict future developments, such as ESG-related news (Serafeim and Yoon, 2022). Notably, recent findings by Park et al. (2022) suggest that financial analysts may have a deeper understanding of operational ESG risks compared to ESG rating agencies. This raises ongoing questions about which intermediaries are most effective at assessing, interpreting, and communicating firm ESG risks.

This study is closely related to prior research examining the relationship between ESG practices and financial performance in the Korean financial market. Earlier studies primarily used the KEJI index to represent ESG-related activities of Korean corporations. The majority of these studies, including Jang and Choi (2010) and Kim and Wee (2011), found a positive relationship between ESG measures and financial performance. However, Na and Hong (2011) reported a negative relationship between environmental protection measures and Tobin's Q but observed a positive relationship between the employee satisfaction index of KEJI and Tobin's Q. Choi, Kwak, and Choe (2010) provided mixed results, showing no conclusive relationship between the KEJI index and accounting-based performance measures.

The limitations of using the KEJI index as a proxy for ESG activities have been widely acknowledged in the literature, particularly in terms of its relation to financial performance. One major issue is that the KEJI index is only available for 200 firms per year, primarily large companies, which introduces potential sample-selection bias. Additionally, the index historically included an economic development contribution component, awarding higher scores to firms with greater earnings. As Cho and Park (2015) demonstrated, the positive relationship between the KEJI index and profitability becomes weaker when controlling for this economic development score.

In contrast, studies using ESG scores from the Korean Corporate Governance Service (KCGS)—a more comprehensive ESG evaluation institution—offer clearer insights into the ESG–financial performance relationship. Yoon, Lee, and Byun (2018) found that ESG practices have a positive and significant impact on market performance, aligning with findings from studies in developed countries. They suggest that ESG's effect on share prices varies depending on firm characteristics. Meanwhile, Lee, Kang, and Kim (2018) reported a negative relationship between total ESG scores and ROE but found no statistically significant relationship with ROA or Tobin's Q. Similarly, Hwang, Kim, and Jung (2021) observed a positive relationship between ESG performance and financial outcomes during the COVID-19 pandemic. They noted that although earnings dropped sharply in the first quarter of 2020, firms with higher ESG performance experienced a smaller decline in earnings.

As discussed, previous studies reveal that the relationship between ESG and financial performance remains inconsistent. This may be attributed to the evolving nature of ESG implementation among Korean firms. Since ESG practices are still in the development phase, firms' commitment to ESG may be perceived as an "uncertain signal" by external stakeholders and investors (Lee and Cho, 2021; Yoon et al., 2018). As a result, the cost associated with ESG activities may negatively affect firm value, reflecting the traditional view that emphasizes profit maximization.

3 Data and Empirical Model

In this study, we utilized the ESG Incident Analysis (IA) index provided by Whosgood to measure ESG incidents. This service analyzes companies' ESG (Environmental, Social, and Governance) risks using AI models based on information collected from news media. The ESG incident score reflects how frequently a company is exposed to various ESG issues, enabling the tracking of ESG risk trends over time or comparisons with other companies within the same industry.

The ESG incident score is assigned based on the severity of identified ESG-related events. Severity is assessed using various criteria, including intent, social/environmental impact, and financial loss. The analysis results are structured into both an overall risk score and category-specific risk scores, ultimately expressed on a scale from 5 to 1. Relevant ESG issues are classified into 17 key categories according to global standards such as the UN Global Compact, ISO 26000, and PRI. These categories include chemical spills and pollution incidents, climate change response, occupational health and safety, human rights violations, ethics, and poor risk management.

The ESG incidents data are compiled based on media coverage. To mitigate potential bias from differences in media exposure, we restrict our sample to firms listed in the KOSPI 200 index and exclude financial firms. Since the dataset provides both the total ESG incident score and its individual components, we directly use these raw scores in our analysis. Financial statement variables are obtained from the Quantiwise software provided by FNguide, a financial information service in Korea, covering the period from 2019 to 2024.

This study adopts a panel regression model with firm-fixed effects as the primary tool to evaluate the relationship between ESG practices and financial performance. Recent studies exploring the relationship between ESG and other corporate policies have highlighted the importance of firm-fixed effects in producing reliable empirical results. For example, Cui, Jo, and Na (2015) included firm-fixed effects in their analysis of the relationship between ESG practices and information asymmetry. Reflecting these advancements in the literature, we incorporate firm-fixed effects in our baseline econometric model, ensuring that our analysis accounts for the substantial heterogeneity in ESG practices across firms.

To accurately assess the economic relationship between ESG practices and profitability, it is essential to address potential omitted variable bias in the empirical model. Margolis and Walsh (2001) identified three key control variables—firm size, industry classification, and market risks—that help mitigate such biases. McWilliams and Siegel (2000) further emphasized the importance of including R&D expenditures and advertising expenses, as they significantly influence firm-level profitability. Additionally, Callan and Thomas (2009) noted that non-linear relationships between these control variables and profitability could also impact the results.

Accordingly, we employ the following empirical models to estimate the relationship between ESG practices and financial performance. Consistent with the approaches of McGuire, Sundgren, and Schneeweis (1997) and Waddock and Graves (1997), we analyze the effect of ESG on financial performance in the subsequent fiscal year. Our econometric model focuses on the linear relationships:

$$FP_t = \alpha + \beta \cdot ESGS_{t-1} + \gamma(CAPEX_t, RD_t, ADV_t, LEV_t, SALES_t, SIZE_t) + u_i + \varepsilon_t, \quad (1)$$

We provide a detailed explanation of the empirical models used in our analysis. To assess financial performance, we rely on two widely recognized metrics. First, Return on Assets (ROA), calculated as operating income divided by total assets from the previous period, reflects the firm's ability to generate profit from its asset base. Second, Return on Equity (ROE), defined as net income divided by the prior period's book equity, evaluates how efficiently a firm utilizes its shareholders' equity to generate profits.

Our control variables follow the approach of Callan and Thomas (2009). To account for firm size, we incorporate three key firm characteristics: SALES is the total sales divided by total assets at time t ; SIZE is the natural logarithm of the firm's total book asset value at time t ; We also include variables reflecting the firm's investment activities, which are essential for determining productivity: CAPEX is the capital expenditure as a percentage of sales at time t ; RD represents research and development (R&D) expenses divided by sales; and ADV is the advertising expense relative to sales at time

t. Additionally, the leverage ratio at time t captures the financial risk associated with the firm.

The rationale for these control variables is as follows: The number of employees and the size of total assets indicate the life cycle stage of the firm—larger, mature firms generally exhibit higher profitability. Companies with significant CAPEX and R&D expenditures are usually growth-oriented, prioritizing long-term investments over short-term profitability. A high leverage ratio may signal financial distress, reducing profitability. Lastly, the sales-to-asset ratio serves as a turnover metric, closely linked to industry-level profitability.

4 Empirical Results

This section presents our empirical findings. We begin by providing descriptive statistics and a correlation matrix. Following this, we perform the main analysis using panel regression models.

Table 1. Summary Statistics

Statistic	N	Mean	St. Dev.	Min	Max
ESG_score	915	1.548	1.282	0.000	4.918
E_score	915	0.254	0.538	0.000	2.536
S_score	915	1.355	1.255	0.000	4.942
G_score	915	0.904	1.016	0.000	4.632
ROA	894	5.234	9.255	-74.920	90.510
ROE	893	5.268	24.916	-320.220	138.840
leverage	901	158.522	229.417	4.010	2,590
size	904	22.448	1.647	16.922	27.263
sales	904	0.787	0.446	0.012	3.152
capex	896	0.066	1.053	-2.877	30.957
advertising_cost	904	0.017	0.051	0.000	0.950
rd	904	0.024	0.151	0.000	4.171

Table 1 provides an overview of the data distribution. On average, firms have a total ESG incidents score of 1.548, with the social component (S_score) exhibiting the highest mean (1.355), followed by governance (0.904) and environmental (0.254) scores. Performance metrics indicate that firms have

an average ROA of 5.234 and ROE of 5.268, though there is significant variability across firms. Financial variables such as leverage, size, and sales-to-assets ratio reflect the diverse characteristics of firms in the sample. Investment activities, captured by capital expenditure, R&D, and advertising ratios, also exhibit considerable variation across firms.

Table 2. Correlation

	ESG	E	S	G	ROA	ROE	lev	size	sales	capex	adv	rd
ESG	1.00	0.56	0.92	0.80	-0.13	-0.06	0.13	0.69	-0.23	-0.03	-0.05	-0.08
E	0.56	1.00	0.41	0.26	-0.03	-0.01	-0.04	0.38	0.00	-0.02	-0.08	-0.04
S	0.92	0.41	1.00	0.60	-0.12	-0.06	0.13	0.64	-0.18	-0.03	-0.04	-0.08
G	0.80	0.26	0.60	1.00	-0.11	-0.05	0.18	0.58	-0.31	-0.03	-0.01	-0.05
ROA	-0.13	-0.03	-0.12	-0.11	1.00	0.74	-0.21	-0.02	0.24	-0.04	-0.24	-0.37
ROE	-0.06	-0.01	-0.06	-0.05	0.74	1.00	-0.31	0.08	0.15	-0.05	-0.17	-0.32
lev	0.13	-0.04	0.13	0.18	-0.21	-0.31	1.00	0.32	-0.19	0.03	-0.04	-0.06
size	0.69	0.38	0.64	0.58	-0.02	0.08	0.32	1.00	-0.21	-0.04	-0.07	-0.11
sales	-0.23	0.00	-0.18	-0.31	0.24	0.15	-0.19	-0.21	1.00	-0.07	-0.20	-0.09
capex	-0.03	-0.02	-0.03	-0.03	-0.04	-0.05	0.03	-0.04	-0.07	1.00	-0.03	-0.01
adv	-0.05	-0.08	-0.04	-0.01	-0.24	-0.17	-0.04	-0.07	-0.20	-0.03	1.00	0.62
rd	-0.08	-0.04	-0.08	-0.05	-0.37	-0.32	-0.06	-0.11	-0.09	-0.01	0.62	1.00

Table 2 shows the correlations among our variables of interests. The environmental (E), social (S), and governance (G) incident scores are highly correlated, with particularly strong correlations between the total ESG incidents score and the social (0.92) and governance (0.80) components. The ESG incidents score is also positively correlated with firm size (0.69) and leverage (0.13), but negatively correlated with the sales-to-assets ratio (-0.23), suggesting that larger firms tend to report more ESG incidents, while firms with higher turnover ratios report fewer. Additionally, both ROA and ROE show weak negative correlations with the ESG incidents score (-0.13 and -0.06, respectively), indicating that firms with more ESG incidents may experience slightly lower profitability. Finally, there is a strong positive correlation between ROA and ROE (0.74), while leverage exhibits negative correlations with both ROA (-0.21) and ROE (-0.31), highlighting the financial stress that high leverage may impose on profitability.

Table 3. Financial Performance and ESG Incidents

	<i>Dependent variable:</i>					
	ROA			ROE		
	(1)	(2)	(3)	(4)	(5)	(6)
ESG_score	-0.925*** (0.241)	-1.631*** (0.293)	-0.860** (0.364)	-1.246* (0.655)	-4.860*** (0.637)	-2.409** (0.938)
size		-1.027** (0.468)	-8.699*** (0.911)		4.071*** (1.016)	-12.494*** (2.347)
sale		2.055*** (0.430)	12.440*** (0.883)		0.387 (0.933)	19.318*** (2.273)
leverage		-0.006*** (0.001)	-0.005*** (0.002)		-0.033*** (0.003)	-0.046*** (0.005)
advertising_cost		-4.294 (7.226)	17.523* (10.439)		-43.543*** (15.689)	44.615* (26.883)
capex		-0.065 (0.258)	0.589*** (0.215)		-0.910 (0.560)	2.356*** (0.554)
rd		-17.296*** (2.440)	-16.244*** (2.670)		-24.454*** (5.299)	-32.618*** (6.876)
Constant	6.692*** (0.489)	-12.759** (5.045)	-70.550*** (16.179)	7.228*** (1.324)	-79.697*** (10.955)	-124.960*** (41.664)
Observations	894	891	891	893	891	891
R ²	0.016	0.205	0.738	0.004	0.241	0.648
Adjusted R ²	0.015	0.199	0.668	0.003	0.235	0.554
Firm F.E.	No	No	Yes	No	No	Yes
Residual Std. Error	9.185	7.936	5.110	24.879	17.232	13.160
F Statistic	14.708***	32.505***	10.514***	3.624*	40.141***	6.883***

Note: *p<0.1; **p<0.05; ***p<0.01

Table 3 summarizes the panel regression results, showing the effect of ESG incident scores on Return on Assets (ROA) and Return on Equity (ROE) across six models. Models (1) to (3) use ROA as the dependent variable, and Models (4) to (6) use ROE. The firm fixed effects are considered in Models (3) and (6), respectively. The coefficients, standard errors (in parentheses), and statistical significance are reported.

The table indicates that the total ESG incidents score negatively impacts both ROA and ROE across all models, with significant effects in several instances. Specifically, the coefficients for the ESG incidents score are significantly negative, with values of -0.925 for ROA and -1.246 for ROE. Including firm fixed effects does not alter the significance or direction of the ESG incidents score, suggesting that the negative relationship between ESG

incidents and financial performance remains robust even when accounting for firm-level heterogeneity.

The inclusion of firm size, sales, leverage, advertising costs, capital expenditures (Capex), and R&D expenditures as control variables provides additional insights. Firm size negatively impacts ROA (Model 3) but shows a positive effect on ROE (Model 5). Sales have a positive influence on both ROA and ROE in multiple models. Leverage exhibits a negative relationship with profitability, as shown by its significant negative coefficients for both ROA and ROE.

Advertising costs and Capex display varied effects. Advertising costs significantly reduce ROE in Model 5 but positively influence ROE in Model 6. Similarly, Capex positively affects ROE in Model 6 but has no significant effect on ROA. R&D expenses consistently show significant negative relationships with both ROA and ROE, indicating potential short-term profitability costs associated with high R&D investments.

These findings are economically significant. The mean levels of ROA and ROE are 5.234 and 5.268, respectively, reflecting the average profitability of the firms analyzed. The standard deviation of the ESG_score is 1.28, indicating considerable variation in ESG performance. An increase of one standard deviation in the ESG incident score leads to a decrease in ROA by approximately 1.1 percentage points and in ROE by about 1.5 percentage points. These reductions in profitability metrics highlight the substantial economic impact of ESG performance, emphasizing the importance of effective governance and ESG risk management to maintain strong financial outcomes.

This negative coefficient is generally in line with the stakeholder theory predicting that ESG efforts positively influence financial performance (Freedman, 1984). In the view of ESG incidents, this might be interpreted as a poorer performance for firms with severe reputational ESG risk. Such risks may hinder corporate performances; firms with large ESG risks may lose potential customers or reduce profit margin to promote sales. These accounting measures, ROA and ROE are closely related to the channel of ESG risks and profitability. This finding is also in line with recent findings for the positive relationship between ESG grades and financial performance in the Korean market as well. (Yoon et al., 2024).

Table 4. Financial Performance and Environmental Incidents

	<i>Dependent variable:</i>					
	ROA			ROE		
	(1)	(2)	(3)	(4)	(5)	(6)
E_score	-0.457 (0.571)	-1.333** (0.553)	-0.091 (0.550)	-0.298 (1.540)	-5.014*** (1.211)	-0.525 (1.417)
size		-1.985*** (0.436)	-8.983*** (0.907)		1.284 (0.955)	-13.274*** (2.337)
sale		2.309*** (0.438)	12.528*** (0.890)		1.236 (0.959)	19.610*** (2.294)
leverage		-0.006*** (0.001)	-0.005*** (0.002)		-0.031*** (0.003)	-0.047*** (0.005)
advertising_cost		-4.357 (7.332)	18.206* (10.482)		-44.312*** (16.056)	46.693* (27.012)
capex		-0.031 (0.262)	0.610*** (0.216)		-0.794 (0.573)	2.414*** (0.556)
rd		-16.948*** (2.477)	-16.354*** (2.680)		-23.205*** (5.424)	-32.930*** (6.906)
Constant	5.353*** (0.343)	0.820 (4.324)	-68.753*** (16.383)	5.345*** (0.924)	-42.462*** (9.467)	-121.076*** (42.218)
Observations	894	891	891	893	891	891
R ²	0.001	0.182	0.736	0.00004	0.207	0.645
Adjusted R ²	-0.0004	0.176	0.665	-0.001	0.200	0.550
Firm FE.	No	No	Yes	No	No	Yes
Residual Std. Error	9.257	8.048	5.130	24.930	17.622	13.220
F Statistic	0.641	28.143***	10.402***	0.038	32.872***	6.786***

Note: *p<0.1; **p<0.05; ***p<0.01

The table provides regression results evaluating the impact of environmental incident scores (E_score) on financial performance, measured by ROA and ROE, across several models. The results indicate that environmental incidents negatively affect both ROA and ROE, but the statistical significance is mixed. Specifically, the relationship is not robust after controlling for firm fixed effects.

For ROA, the environmental incident score shows a significant negative effect only in Model (2), with a coefficient of -1.333, indicating that environmental risks reduce profitability under certain conditions without fixed effects. However, in Models (1) and (3), the E_score is not statistically significant, suggesting that the impact of environmental risks on profitability is not consistent across all specifications, and the negative relationship appears non-robust.

The results are similar for ROE. The coefficient is significantly negative at -5.014 in Model (5), indicating a strong negative impact. However, in Model (6), the effect remains negative, with a coefficient of -0.525, but it loses statistical significance. This suggests that environmental incidents may not be closely associated with lower returns on equity.

For other control variables, firm size negatively affects ROA in Models (2) and (3), implying that larger firms may encounter challenges in maintaining asset-based profitability. However, firm size positively influences ROE in Model (5) but shows a negative effect in Model (6), suggesting that its impact on equity returns depends on the model specification. Sales consistently show a positive and significant relationship with both ROA and ROE across all models, highlighting the importance of revenue generation for firm performance.

Table 5. Financial Performance and Social Incidents

	<i>Dependent variable:</i>					
	ROA			ROE		
	(1)	(2)	(3)	(4)	(5)	(6)
S_score	-0.876*** (0.246)	-1.436*** (0.282)	0.083 (0.339)	-1.123* (0.668)	-3.740*** (0.617)	0.186 (0.873)
size		-1.396*** (0.450)	-9.023*** (0.918)		2.718*** (0.985)	-13.381*** (2.366)
sale		2.258*** (0.430)	12.525*** (0.887)		0.966 (0.943)	19.549*** (2.285)
leverage		-0.006*** (0.001)	-0.006*** (0.002)		-0.032*** (0.003)	-0.047*** (0.005)
advertising_cost		-2.796 (7.246)	18.199* (10.479)		-39.388** (15.874)	46.479* (27.004)
capex		-0.043 (0.259)	0.611*** (0.216)		-0.847 (0.567)	2.417*** (0.556)
rd		-17.447*** (2.447)	-16.357*** (2.680)		-24.816*** (5.361)	-32.933*** (6.907)
Constant	6.441*** (0.458)	-9.639** (4.858)	-68.029*** (16.274)	6.812*** (1.240)	-64.915*** (10.643)	-118.090*** (41.941)
Observations	894	891	891	893	891	891
R ²	0.014	0.201	0.736	0.003	0.224	0.645
Adjusted R ²	0.013	0.194	0.665	0.002	0.217	0.550
Firm F.E.	No	No	Yes	No	No	Yes
Residual Std. Error	9.195	7.958	5.130	24.891	17.433	13.221
F Statistic	12.640***	31.641***	10.403***	2.826*	36.328***	6.784***

Note: *p<0.1; **p<0.05; ***p<0.01

The table presents the panel regression results evaluating the impact of social incident scores (S_score) on financial performance, using ROA and ROE as dependent variables across multiple models. The results indicate that social incidents negatively influence both ROA and ROE, though the significance varies depending on the model specifications.

The findings for social incidents are similar to those for environmental incidents. For ROA, the S_score shows a negative effect when the fixed effect is not considered. It is statistically significant in Model (2) with a coefficient of -1.436, indicating that social incidents reduce ROA when controls are applied without fixed effects. However, the S_score loses significance in Model (3) when firm-level fixed effects are included, suggesting that unobserved firm characteristics may moderate the impact of social incidents on ROA.

The results for ROE follow a similar pattern. The coefficient is significantly negative at -3.740 in Model (2), indicating a strong negative impact. However, in Model (6), the effect remains negative, with a coefficient of -0.186, but it loses statistical significance. This suggests that social incidents may not have a consistent or robust association with lower returns on equity.

The behavior of the control variables is consistent across models, as observed in the previous results, reaffirming their importance in the analysis.

Table 6. Financial Performance and Governance Incidents

	<i>Dependent variable:</i>					
	ROA			ROE		
	(1)	(2)	(3)	(4)	(5)	(6)
G_score	-1.004*** (0.303)	-0.853** (0.335)	-1.100*** (0.384)	-1.181 (0.820)	-3.118*** (0.733)	-3.098*** (0.989)
size		-1.514*** (0.486)	-8.822*** (0.903)		2.997*** (1.065)	-12.834*** (2.325)
sale		1.918*** (0.448)	12.314*** (0.883)		-0.204 (0.980)	18.962*** (2.273)
leverage		-0.006*** (0.001)	-0.005*** (0.002)		-0.032*** (0.003)	-0.046*** (0.005)
advertising_cost		-4.420 (7.330)	16.899 (10.426)		-44.463*** (16.048)	42.847 (26.837)
capex		-0.082 (0.262)	0.592*** (0.215)		-0.981* (0.573)	2.365*** (0.552)

rd		-17.223***	-16.193***		-24.240***	-32.473***
		(2.474)	(2.665)		(5.415)	(6.861)
Constant	6.160***	-0.708	-65.050***	6.356***	-47.606***	-109.506***
	(0.416)	(4.547)	(16.164)	(1.125)	(9.954)	(41.610)
Observations	894	891	891	893	891	891
R ²	0.012	0.183	0.739	0.002	0.208	0.650
Firm F.E.	No	No	Yes	No	No	Yes
Adjusted R ²	0.011	0.177	0.669	0.001	0.201	0.556
Residual Std. Error	9.204	8.045	5.101	24.901	17.612	13.130
F Statistic	10.976***	28.263***	10.566***	2.075	33.044***	6.931***

Note: *p<0.1; **p<0.05; ***p<0.01

Table 6 presents the panel regression results examining the effect of governance incident scores (*G_score*) on financial performance, using ROA and ROE as dependent variables across several models. The findings indicate that governance incidents negatively impact both ROA and ROE, although the magnitude and significance of these effects vary.

For ROA, the governance incident score consistently shows negative coefficients across Models (1) to (3). In Model (1), the coefficient is -1.004, suggesting a significant adverse effect on ROA. This negative impact remains statistically significant in Models (2) and (3), with coefficients of -0.853 and -1.100, respectively, even after accounting for firm-level controls. These results imply that governance risks consistently reduce ROA across different model specifications.

The regression results for ROE confirm the robustness of these findings. The governance incident score also exhibits a consistently negative effect. In Model (5), the coefficient is -3.098, indicating that governance incidents significantly lower returns on equity. Although the inclusion of firm fixed effects reduces the magnitude of the effect, it remains statistically significant. This suggests that governance incidents negatively impact equity performance, but certain firm-level characteristics may moderate this relationship.

These findings demonstrate notable economic significance. The mean values of ROA and Return on Equity are 5.234 and 5.268, respectively, indicating the average profitability of the firms in the sample. Additionally, the standard deviation of the governance incident score (*G_score*) is 1.016, reflecting the variation in governance practices among these firms. Importantly, an increase of one standard deviation in the *G_score* is

associated with a reduction in ROA and ROE by approximately 1 and 3 percentage points, respectively. This effect represents a substantial economic impact, as it highlights how governance risks can significantly erode profitability metrics.

These findings suggest that the negative relationship between ESG incidents and profitability is primarily driven by governance-related incidents. In other words, firms experiencing governance issues may suffer poorer accounting performance. For example, a firm facing disputes over management control may struggle to operate efficiently during the fiscal year, resulting in weaker financial outcomes. The substantial media attention these governance issues often attract further highlights the seriousness of such problems, potentially leading to even poorer financial performance for the corporation.

The observed significant relationship between governance incidents and financial performance underscores the critical role that regulatory agencies play in promoting robust corporate governance. To mitigate the potential financial and reputational repercussions of governance failures, regulatory agencies may require firms to disclose comprehensive and detailed information specifically targeting governance-related risks and the strategies employed to mitigate them.

This mandate may prioritize periodic and standardized reporting on essential facets of corporate governance. These include the structure, composition, and independence of the board of directors, ensuring that boards are well-equipped to provide effective oversight. Firms should also detail the qualifications, diversity, and expertise of board members, as these factors contribute to balanced decision-making and effective leadership. Transparent reporting on decision-making processes, including how major corporate strategies and risk management decisions are formulated, should be a cornerstone of these disclosures.

Additionally, firms may outline the mechanisms they have in place to identify, assess, and address governance vulnerabilities, such as gaps in internal controls, exposure to conflicts of interest, or deficiencies in oversight mechanisms. Clear documentation of policies governing executive compensation, including how it aligns with long-term corporate goals and shareholder value, is equally crucial. Similarly, firms should disclose their approaches to shareholder engagement, demonstrating how they incorporate stakeholder feedback into governance practices.

5 Conclusion

This study provides new insights into the relationship between ESG incidents and financial performance, focusing on firms listed on the KOSPI 200 from 2019 to 2023. While prior research has explored the link between ESG scores and financial outcomes, our work is the first to specifically examine the effect of ESG incidents within the Korean market. ESG incidents, which capture materialized risks related to environmental, social, or governance issues, offer a unique perspective on how reputational risks affect corporate profitability.

Our findings reveal a negative relationship between ESG incidents and accounting performance, as measured by ROA and ROE. Firms with higher reputational risks reported in the media tend to exhibit lower profitability, and this relationship remains robust even after controlling for firm fixed effects. This result supports the relevance of stakeholder theory (Freeman, 1984), which highlights the importance of addressing stakeholder interests for maintaining financial performance. Moreover, our results align with the recent findings of Yoon et al. (2024), which confirm a positive relationship between ESG grades and financial outcomes in the Korean context.

One of the key contributions of this study is the identification of governance incidents as the primary driver of the negative relationship between ESG incidents and financial performance. Governance risks consistently show a strong negative impact on both ROA and ROE, and these effects remain significant across various model specifications. In contrast, environmental and social incidents do not exhibit the same robustness. Once firm-level fixed effects are included, the relationship between environmental and social scores and profitability becomes statistically insignificant. This finding underscores the critical role of governance issues in shaping financial outcomes. Given that media tends to focus on significant governance issues, these incidents may signal deeper managerial inefficiencies, leading to poor operational performance and financial losses.

Our study contributes to the literature by addressing a gap related to the impact of ESG incidents. While previous studies focused primarily on ESG scores, our work demonstrates the importance of analyzing incident-based measures, despite the challenges involved in constructing such datasets. The

significance of governance issues highlighted in our findings aligns with the idea that governance is a crucial determinant of operational performance, further supporting the role of stakeholder engagement in corporate success.

The significant relationship between governance incidents and financial performance highlights the critical role of regulatory agencies in promoting strong corporate governance. To mitigate the financial and reputational risks of governance failures, regulators may mandate comprehensive and standardized disclosures on governance-related risks and mitigation strategies. These may include periodic reporting on board structure, independence, qualifications, and diversity, as well as transparency in decision-making processes and mechanisms for identifying and addressing governance vulnerabilities. Firms might also disclose policies on executive compensation, internal controls, conflict-of-interest management, and shareholder engagement. Such measures will enhance accountability, enable informed stakeholder decisions, and foster resilient governance practices.

In conclusion, this study confirms the relevance of stakeholder theory in a developing market like Korea. By showing that governance-related ESG incidents have a material impact on firm performance, we contribute to a deeper understanding of the relationship between ESG risks and financial outcomes. Future research could extend our work by exploring how firms can mitigate the negative impact of governance issues and by developing more comprehensive measures for ESG incidents.

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