

How Do Investors Penalise ESG Misconduct? Evidence for the Most Admired European Companies on Access to Finance

Emma García-Meca¹, Camino Ramón-Llorens¹, and Jennifer Martínez-Ferrero^{2,*}

¹ Department of Financial Economics and Accounting, Faculty of Business Studies, Polytechnic University of Cartagena, Cartagena, Spain

² Department of Business and Administration, Faculty of Business and Economics, University of Salamanca, Salamanca, Spain

Email: emma.garcia@upct.es (E.G.M.); camino.ramon@upct.es (C.R.L.); jenny_marfe@usal.es (J.M.F.)

*Corresponding author

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Abstract—This paper examines the impact of Environmental, Social and Governance (ESG) misconduct on firms' financial access. Examining European firms from 2015 to 2020, we find that engaging in irresponsible ESG actions leads to worse access to finance conditions, characterised by higher financial constraints. Moreover, the influence of such irresponsible behaviour in ESG is sufficiently robust to attenuate the positive effect that a solid corporate reputation could exert on credit access.

Keywords—Environmental, Social and Governance (ESG) misconduct, ESG, reputation, financial constraints

I. INTRODUCTION

Building upon the stakeholder theory, previous literature has devoted significant attention to exploring the potential benefits of Environmental, Social and Governance (ESG) activities, particularly in terms of their impact on firm performance (El Khoury *et al.*, 2022), dividend payouts (García-Meca *et al.*, 2022), image and reputation (Maden *et al.*, 2012), lower risk and information asymmetry (Desender *et al.*, 2020), and employees' attitudes and behaviour (Wang *et al.*, 2020). However, not all companies exhibit desirable behaviour in terms of ESG. In general, research on the adverse effects of ESG misconduct is limited. A recent literature review has highlighted the various effects of this misconduct from different perspectives, emphasising the consequences for external and internal stakeholders (see Iborra & Ribeiro, 2023), including actions related to bribery, corruption, labour exploitation, environmental pollution, human rights abuses, discrimination and unsafe working conditions that impact stakeholders and society, either intentionally or unintentionally (Riera & Iborra, 2017). ESG behaviour encompasses responsible and irresponsible actions, which differ in nature and operate differently. It is crucial to consider both aspects because a company that demonstrates high levels of social responsibility may still engage in irresponsible practices (Tang *et al.*, 2015). Moreover, it is important to highlight that while Corporate Social Irresponsibility (CSI) was initially proposed as the opposite of Corporate Social Responsibility (CSR) (Clark *et al.*, 2022; Riera and Iborra, 2017), contemporary perspectives widely acknowledge that CSR and CSI represent distinct constructs. In this regard, the literature suggests that organisations may engage in controversial activities while adopting practices aimed at social responsibility.

The broadcasting role of the media and its coverage of adverse ESG activities, along with international regulatory pressure on firms for sustainability compliance, have intensified the debate on the effects of unethical corporate

ESG behaviour. Fu (2023), supported by the signalling theory, defends that negative media coverage of ESG serves as credible and salient signalling feedback on firms' ESG performance. Since irresponsible social actions increase firm risk more than responsible actions reduce it (Chava, 2014), the effects of ESG wrongdoing can have a serious impact on firms' access to funding. In fact, financial institutions integrate firms' ESG information into their loan assessments to evaluate two distinct risks associated with these firms: the risk of default and the risk to their reputation. Therefore, companies that violate ethical and responsible principles may have a higher risk of failing to make payments or fulfil their financial obligations (Zhao *et al.*, 2018) or of violating ESG regulations, which may result in banks being less willing to lend them money. According to the previous literature, ESG failures lower the capital market's assessment of the operational capacities of the firms involved (Antonetti *et al.*, 2020), raising their perceived risk (Kanuri *et al.*, 2020) and increasing their reputational risk (Becchetti & Manfredonia, 2022) and the cost of equity (Becchetti *et al.*, 2023).

In this context, the increasing international regulatory pressure on sustainability issues, exemplified by regulations such as the EU Sustainable Finance Disclosure Regulation (2019) and the EU Taxonomy Regulation (2020), has prompted investors and financial institutions to adopt a sustainable approach and demand a risk premium from non-ESG compliant companies. As a result, we suggest that investors and financial institutions may be less willing to provide loans or financing to companies with poor reputations in ESG-related matters. Additionally, companies that fail to adhere to ESG practices may encounter heightened capital constraints due to increased agency costs and informational asymmetry arising from limited or unreliable ESG practices (Cheng *et al.*, 2014).

Despite the well-documented cases of ESG failures and the existing academic literature on their effects on financial risk (Kölbel *et al.*, 2017) and firms' cost of funding (Becchetti *et al.*, 2023), to the best of our knowledge, the literature studying the effect of misconduct in ESG corporate practices on access to financial resources is scarce.

The main objective of this article is to analyse whether firms that receive negative media coverage of ESG failures experience greater financial restrictions. The second part of the paper, based on the cognitive dissonance theory (Festinger, 1957) and the expectancy violations theory (Burgoon, 1978), aims to identify the moderating variables that can influence the relationship between ESG misconduct and financial access, with a particular focus on firm reputation.

The dataset used for analysis consists of 2,730 European firm-year observations from 455 different firms, covering the period from 2015 to 2020. Empirically, our findings show that firms engaging in ESG misconduct strategies face higher financial constraints, leading to worse financing conditions. Interestingly, these results hold true even when firms are globally admired and highly reputable.

II. LITERATURE REVIEW

A. ESG Misconduct and Financial Constraints

ESG encompasses environmental, social and governance factors that influence stakeholders' investment decisions (Galbreath, 2013). Drawing on the stakeholder theory, the literature highlights the positive outcomes associated with implementing ESG activities. Previous studies show that implementing these ESG practices helps the company to send positive signals to the financial market, leading to reduced stock price volatility and increased transparency (El Ghoul *et al.*, 2011). Moreover, taking responsible ESG actions protects against the reputational damage that can stem from failures in business management (Godfrey *et al.*, 2009). As a result, these companies are more likely to receive financial rewards (Cheng *et al.*, 2014) and have better access to low-cost external funding (El Khoury *et al.*, 2022). Furthermore, ESG practices influence business managers' investment decisions by shaping their behaviour and promoting effective capital allocation (Lu *et al.*, 2023). These findings are supported by Ghoul *et al.* (2017), who demonstrate that socially responsible practices can lower the cost of equity capital and reduce companies' risk exposure, thereby alleviating financial constraints (Zhang & Lucey, 2022).

To date, several studies have investigated the impact of engaging in controversial ESG activities on stakeholders' perceptions and the potential risk to a firm's legitimacy. Poor ESG behaviour can expose a company to legal action or regulatory sanctions, leading to scrutiny from stakeholders (Boffo & Patalano, 2020). This, in turn, can result in brand damage (Green & Peloza, 2014), consumer boycotts (Friedman, 1999) and negative media coverage (Lindenmeier *et al.*, 2012). These issues pose risks to a firm's value (Groening & Kanuri, 2013), and long-term competitive advantage (Chiu & Sharfman, 2018), highlighting the significant role of ESG misconduct. However, there is a gap in the literature regarding how the risk resulting from unethical ESG behaviour affects a company's ability to secure external financing and its associated cost. ESG issues are considered crucial in assessing a company's risk profile and future preparedness (PwC, 2020). When a financial institution evaluates whether to provide funding to a company, it faces an information asymmetry problem, which is further exacerbated in situations of risk caused by negative media coverage of irresponsible ESG actions.

According to the signalling theory, companies use ESG actions as positive signals to gain or influence stakeholder support (Shou *et al.*, 2020). Some studies suggest that firms engage in socially responsible activities to mask or compensate for ESG failures. However, when a company performs poorly in ESG, it may send negative signals to financial institutions regarding its risk management

capabilities and long-term value generation (Aust *et al.*, 2020). ESG misconduct signals can lead the capital market to question the accuracy of a company's financial statements, lower the market's assessment of the firm's operational capabilities (Antonetti *et al.*, 2020) and increase the perceived level of risk associated with the company (Kanuri *et al.*, 2020). Irresponsible ESG actions are also associated with potential future sanctions from stakeholders, further increasing financial risk (Kölbel *et al.*, 2017) and hindering the company's ability to acquire capital (Price & Sun, 2017).

Moreover, following the agency theory, the increased accessibility of reliable data about a firm's CSR strategies contributes to reducing informational asymmetry and subsequently leads to diminished capital constraints (Chen *et al.*, 2014). Therefore, firms that do not adhere to ESG practices may face greater capital constraints due to increased agency costs and the heightened informational asymmetry arising from limited or unreliable CSR disclosure practices and transparency. The literature shows that dishonest ESG practices increase the cost of equity capital and debt for firms (Dhaliwal *et al.*, 2011).

Given the existing research gap regarding the impact of dishonest ESG conduct on a company's ability to secure external finance, we propose the following hypothesis:

Hypothesis 1: Companies engaged in ESG misconduct are expected to experience more challenging conditions in accessing finance.

B. The Moderating Role of Corporate Reputation in ESG Misconduct and Financial Constraints

After hypothesising the negative impact of ESG misconduct on access to financing, we aim to explore the potential moderating factors that could help mitigate the financial restrictions following unethical practices. One such factor is corporate reputation, defined as a perceptual construct that reflects past positive corporate behaviour and long-term prospects, demonstrating a firm's commitment to meeting stakeholders' expectations (Helm & Tolsdorf, 2013).

Several studies have examined the relationship between firm reputation and ethical behaviour. Sen and Bhattacharya (2001), among others, have found that firms use ESG initiatives to promote societal well-being and enhance their reputation. According to Zhang *et al.* (2022), a well-managed and effective business reputation can accumulate over time, allowing stored goodwill to mitigate the negative implications of adverse publicity, a phenomenon known as the buffering effect (Chintrakarn *et al.*, 2020). Consequently, investors may be more inclined to overlook ESG issues and continue providing financial resources to these companies. Previous research supports the idea of the buffering or insurance effect of reputation, which, drawing on the cognitive dissonance theory (Festinger, 1957), refers to the ability of a positive reputation to mitigate or protect individuals, brands or businesses from the adverse consequences of negative events or situations (Jonkman *et al.*, 2020). In the context of irresponsible ESG conduct, a solid track record of ESG initiatives generates moral capital or goodwill by signalling a company's commitment to responsible behaviour. This moral capital or goodwill also acts as an insurance-like benefit, safeguarding shareholder

value in the face of negative events (Kölbel *et al.*, 2017).

However, an alternative perspective challenges the idea that moral capital or goodwill provides an insurance-like benefit that protects shareholder value during negative events. Critics argue that a company's reputation and ethical conduct may not necessarily shield it from the adverse effects of such events. In fact, some research raises concerns that a positive reputation may backfire and cause even more severe damage to enterprises, a phenomenon known as the "boomerang effect".

This perspective is supported by the Expectancy Violations Theory (EVT) (Burgoon, 1978), which examines how individuals respond to unexpected violations of social norms and expectations. Individuals have specific expectations of how an organisation should behave, but companies can engage in socially irresponsible activities that violate stakeholders' expectations (Park *et al.*, 2019).

From this perspective, we propose the following hypothesis:

Hypothesis 2: Despite their solid reputation, companies that engage in ESG misconduct still face financial constraints.

III. MATERIALS AND METHODS

A. Data and Sample

Data was collected from the Compustat database, focusing on publicly listed European firms from 2015 to 2020. This resulted in a dataset comprising 3,000 firm-year observations from 500 unique firms, encompassing economic, financial, accounting and ESG information. Additional data on firms' hierarchy was collected from BoardEx. Finally, previously collected data was merged with information on irresponsible ESG actions sourced from Thomson Reuters Refinitiv. Firms without information or data in all three databases were excluded from the analysis. The final sample consisted of 2,730 firm-year observations from 455 unique firms, covering the period from 2015 to 2020.

B. Variable Definitions and Measurement Financial constraints

Following the previous literature (e.g., Anagnostopoulou *et al.*, 2021; Lee & Wang, 2023; Bin-Feng *et al.*, 2023), this paper employs the KZ index developed by Kaplan and Zingales (1997) as a reverse measure of access to finance. The KZ index is closely linked to corporate liquidity and assesses the firm's capacity to generate sufficient cash to fulfil its requirements. The KZ index is calculated as follows:

$$KZ = -1.002 \frac{CF}{lagA} - 39.638 \frac{DIV}{lagA} - 1.315 \frac{C}{lagA} + 3.139LEV_{it} + 0.283Q_{it}$$

where CF represents cash flow, lagA represents total assets in the previous year, DIV represents the cash dividends paid by the company in the current year, C represents cash, LEV represents the amount of leverage in the firm's capital structure and Q represents the market value of equity. It is important to note that a higher value in the KZ index indicates that firms face more constraints when accessing finance.

ESG misconduct

The explanatory variable, ESG misconduct (ESGControversies), is measured by the negative media coverage of ESG practices (Burke, 2021). The sentiment score is derived from the raw count of stories labelled negative by the model from an investor's perspective. A negative sentiment score indicates that companies are involved in adverse actions and events, such as violating environmental and labour laws, causing harm to the natural environment, losing lawsuits, failing to acknowledge or manage risks and engaging in poor labour practices in subcontractor factories, among other negative behaviours (Capelle-Blancard & Aurélien Petit, 2019). If a company is not involved in any controversies, it receives a controversy score of 100 in the Refinitiv database. For readability purposes, we multiply the ESG controversy score by -1 so that irresponsible ESG behaviour will increase the ESG controversy score. Therefore, a firm with high ESG misconduct scores closer to 0, and a firm with no controversy has a score of -100.

Corporate reputation

Data on corporate reputation was collected using a commonly used methodology based on the Fortune Index ranking of the world's most admired companies (Martínez-Ferrero *et al.*, 2016). Following Martínez-Ferrero *et al.* (2016), Reputation is represented as a binary variable, coded as one if companies are included in the World's Most Admired Companies ranking in a given year and zero otherwise.

C. Econometric Model

Our research design uses balanced panel data from European firms, consisting of 2,730 firm-year observations from 2015 to 2020. To analyse the panel data, we employ the dynamic panel Generalised Method of Moments (GMM) technique (Arellano & Bond, 1991). To investigate the impact of ESG misconduct on firms' access to finance and the potential moderating role of corporate global reputation, we employ the following multivariate regression models. Model 1 examines the effect of irresponsible ESG activities on financial constraints by testing the financial consequences of ESG failures on firms' access to finance. Model 2 investigates whether corporate reputation further influences access to finance by exacerbating financial constraints.

IV. RESULT AND DISCUSSION

Table 1 presents the results of the two-step GMM estimations, indicating that worse access to finance conditions is a limiting mechanism for firms engaging in irresponsible ESG actions. The findings also suggest that firms engaging in such misconduct are penalised with higher financial constraints and consequently face difficulties accessing financial resources. Furthermore, the results indicate that, regardless of global reputation, the capital market penalises companies involved in ESG misconduct by imposing worse access to finance conditions. This highlights the importance of considering the impact of ESG actions on financial constraints and the need for responsible practices to safeguard the interests and demands of shareholders and stakeholders.

Table 1. ESG misconduct, financial constraints and corporate reputation

	Model 1		Model 2	
	Coef.	St.Dev.	Coef.	St.Dev.
Independent and moderating variables				
ESGControversies	0.0364**	0.0149	0.0009**	0.0004
Reputation			-1.6483***	0.1591
ESGControversies*Reputation			0.0090***	0.0027
Control variables				
Lag_KZ	0.4676***	0.0985	-0.2009***	0.0032
Size	-0.2045	0.3626	5.1097***	0.0760
Leverage	0.0196	0.0298	0.0116***	0.0006
ROA	-0.0020*	0.0232	-0.0119***	0.0016
CostCapital	0.0020	0.0014	-0.0002***	0.0000
ESG	-0.0604*	0.0433	0.0137***	0.0030
CSRAss	1.0562	1.0711	-1.3177***	0.0600
Controlled by industry, year and country				
Sample: 2,730 observations in the period 2015–2020.				
*, ** and *** represent statistical significance at 10%, 5% and 1%, respectively.				

V. CONCLUSION

Based on a sample of European firms from 2015 to 2020, this paper provides evidence that firms experience worsened access to finance conditions, characterised by greater financial constraints, when they engage in irresponsible ESG actions. Our results also reveal that even with a better corporate reputation, companies that engage in irresponsible ESG actions continue to face financial penalties. Despite their solid reputations, our findings indicate that investors and the capital market are still prone to penalising companies involved in ESG misconduct by limiting their access to financial resources. While reputable companies may have more goodwill and brand recognition among stakeholders, they are also subject to greater scrutiny and held to higher standards. As a result, our study demonstrates that regardless of their reputation, European companies will face increased financial constraints if they choose to engage in irresponsible ESG actions that undermine the interests and demands of shareholders and stakeholders.

This paper makes several academic and practical contributions. Firstly, it shifts the focus from studying the consequences of irresponsible ESG actions to examining how investors and capital markets react to these damaging strategies that harm stakeholders. Prior literature has largely neglected this aspect, instead focusing on the benefits of ESG engagement in reducing capital constraints and improving financial conditions. By exploring the reverse effect, this paper responds to the need for a better understanding of the damage caused by corporate misconduct and the use of monitoring and bonding mechanisms to combat such behaviour. Secondly, this paper contributes to the legitimacy theory and the debate surrounding the substantive versus symbolic role of ESG engagement. It supports the perspective that companies prioritising the substantive role of ESG are likely to gain enhanced stakeholder trust, better financial access and a competitive advantage. By highlighting the substantive role of irresponsible ESG actions, this study advances our understanding of organisations' responses to ESG disengagement and the significance of ESG practices in creditworthiness assessments by lending institutions. Additionally, it underscores the credibility and legitimacy of the media as an external driver shaping corporate responses to sustainability concerns. Thirdly, this paper contributes to the corporate reputation literature and

aligns with the theory of expectancy violations. It identifies that even the most admired and reputable firms in the world face the same consequences as other firms when it comes to ESG misconduct. This finding challenges the notion that moral capital alone can sufficiently protect shareholder value during negative events. It highlights that negative ESG incidents, such as environmental scandals, product failures or ethical lapses, can significantly damage a company's financial access, regardless of its prior reputational capital. Lastly, the findings related to the consequences of ESG misconduct have important implications for government and financial regulators. Understanding the adverse outcomes associated with non-compliance or irresponsible ESG practices enables regulators to refine and strengthen their regulations.

CONFLICT OF INTEREST

The authors declare no conflict of interest.

AUTHOR CONTRIBUTIONS

Martínez-Ferrero and García-Meca design the paper; Martínez-Ferrero analyze the data and regress models; Ramón-Llorens write the theoretical part and propose hypotheses; García-Meca conceptualized the paper and wrote the theoretical background and discussion; all authors have wrote the paper and approved the final version.

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