Environmental, Social, and Governance (ESG) Performance and Earnings Management: The Role of Audit Quality

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Abstract
Earnings management practices triggered by information asymmetry remain an important issue that can reduce the quality of corporate financial reporting. To enhance transparency, increasing attention has been directed toward Environmental, Social, and Governance (ESG) Performance and Audit Quality as monitoring mechanisms. This study aims to examine the effect of ESG Performance on accrual-based Earnings Management and to investigate the role of Audit Quality as a moderating variable. The sample consists of 238 observations of non-financial companies listed on the Indonesia Stock Exchange (IDX) during the 2020-2024 period. Earnings Management is measured using discretionary accruals (Modified Jones Model), while Audit Quality is proxied by Big 4 audit firm affiliation. The analysis employs Moderated Regression Analysis (MRA). The results show that ESG Performance has a significant negative effect on Earnings Management, indicating that the better a company's ESG performance, the lower its Earnings Management practices. However, Audit Quality does not significantly moderate this relationship. These findings indicate that ESG serves as an effective transparency mechanism in reducing opportunistic managerial behavior, regardless of Big 4 audit firm affiliation.

Keywords: Earnings Management, ESG, Audit Quality.

INTRODUCTION

Financial statements are primary instruments providing information regarding a company's performance and financial position, simultaneously reflecting management's accountability in managing corporate resources (Anisykurlillah et al., 2023). However, the preparation process still faces the risk of Earnings Management practices, namely managers' actions utilizing specific judgments in financial reporting to influence accounting information and contractual outcomes based on accounting figures (Healy & Wahlen, 1999). One of the most frequently encountered forms is accrual-based Earnings Management, which exploits the flexibility of accounting standards in determining the timing of revenue and expense recognition without directly affecting the company's cash flows (Dechow et al., 1995). Such practices have been discovered in various companies at both global and national levels. Internationally, this occurred with Kraft Heinz and Under Armour in 2021. Meanwhile, in Indonesia, there have been several cases related to the quality of financial reporting, such as the financial statement restatement of PT Waskita Karya Tbk (2023), inventory recording issues at a subsidiary of PT Kimia Farma Tbk (2024), and allegations of transaction engineering at PT Indofarma Tbk (2024) and eFishery (2024). These cases indicate that earnings management remains a critical issue that can affect the quality of financial information and decision-making by investors.

In response to the risk of manipulation in financial reporting, the focus of corporate transparency is currently no longer limited to financial data but has expanded to non-financial information through Environmental, Social, and Governance (ESG) disclosures, which have been regulated by OJK Regulation No. 51/POJK.03/2017. From the perspective of Stakeholder Theory, companies that implement ESG well tend to be more open and accountable, thus having a lower tendency to

engage in Earnings Management as they strive to maintain the trust of stakeholders (Freeman, 1984; Jafar et al., 2024). Nevertheless, findings from previous studies remain inconsistent. Primacintya and Kusuma (2025) showed that an increase in ESG Performance is associated with a decrease in Earnings Management. Conversely, Almubarak et al. (2023) found contrasting results, suggesting that ESG disclosure can actually be associated with increased Earnings Management, indicating that ESG also has the potential to be utilized to build a positive corporate image while simultaneously obscuring earnings manipulation practices. These differing research results suggest that ESG Performance may not necessarily suppress Earnings Management practices without the support of effective monitoring mechanisms (García-Sánchez et al., 2022). Despite the growing literature on ESG Performance and Earnings Management, empirical evidence regarding the role of Audit Quality in strengthening this relationship remains limited and inconclusive, particularly in emerging markets such as Indonesia. Therefore, the novelty of this study lies in examining Audit Quality as a moderating variable in the relationship between ESG Performance and Earnings Management among Indonesian non-financial firms using recent data from 2020–2024. By incorporating Audit Quality into the ESG–Earnings Management framework, this study extends prior literature and provides additional evidence regarding the interaction between sustainability performance and external monitoring mechanisms. Considering the importance of effective monitoring mechanisms, this study uses Audit Quality as a moderating variable proxied through Big 4 Public Accounting Firm (KAP) affiliation (DeAngelo, 1981). Big 4 auditors generally possess better resources, competence, and independence in detecting accrual manipulation practices (Francis, 2004). Thus, Audit Quality is expected to strengthen the role of ESG in promoting financial reporting transparency and reducing the likelihood of utilizing ESG disclosures merely as a public relations tool.

Agency Theory

According to Jensen and Meckling (1976), Agency Theory explains the contract-based cooperative relationship between shareholders as principals and management as agents. Under these conditions, day-to-day corporate management and operational decision-making rest in the hands of management as the mandated party. The separation of roles between owners and managers often gives rise to a divergence of interests, as each party does not always share the same orientation. Management tends to pursue short-term targets or maintain a performance image, which may not align with the shareholders' interests in sustainably increasing firm value. This divergence of objectives is further exacerbated by information asymmetry, a condition where management has deeper access to internal corporate information compared to the owners. This information imbalance can create opportunities for opportunistic actions, which ultimately have the potential to harm shareholders in the long run.

Stakeholder Theory

According to Stakeholder Theory, a company's orientation is not solely aimed at fulfilling shareholder interests, but also includes attention to various parties connected to corporate activities, such as employees, suppliers, consumers, society, and the environment (Freeman, 1984). This perspective asserts that a company's long-term sustainability is heavily determined by the extent to which it can build support and gain legitimacy from stakeholders. Therefore, assessing corporate performance is not sufficient when viewed merely from a financial standpoint; it is also necessary to consider non-financial aspects that reflect

corporate responsibility. This situation ultimately encourages companies to enhance information disclosure so that potential conflicts with external parties can be suppressed while maintaining a stable corporate reputation in the long term.

Earnings Management

According to Healy and Wahlen (1999), Earnings Management can be understood as management's attempt to arrange the earnings figures appearing in financial statements by exploiting the flexibility of accounting policies and the use of estimates within an accrual-based system. This practice is generally carried out to achieve specific financial targets in line with management's interests. From the perspective of Agency Theory, Earnings Management emerges as a consequence of conflicts of interest triggered by information asymmetry between the agent and the principal. The agent utilizes internal information they master to influence earnings reporting to fulfill opportunistic goals, such as obtaining bonuses or maintaining a professional image. Such conditions can degrade the quality of financial statements and potentially harm the principal's interests.

ESG Performance

Environmental, Social, and Governance (ESG) Performance demonstrates a company's ability to integrate environmental, social, and governance aspects into operational activities and implemented business strategies (Wong et al., 2023). High ESG Performance can reflect the company's commitment to more accurate and sustainable non-financial information disclosure. In the perspective of Stakeholder Theory, ESG implementation is viewed as a corporate effort to fulfill the expectations and interests of stakeholders. Companies that apply sustainability principles generally treat ESG practices as a form of corporate responsibility and accountability. This situation has the potential to enhance management's commitment to transparency, thereby suppressing manipulative practices in financial reporting, such as Earnings Management, in order to maintain public trust.

Audit Quality

Audit Quality refers to the probability that an auditor is able to detect and report violations or material misstatements in the company's financial information system (DeAngelo, 1981). High audit quality is generally proxied through corporate affiliation with Big 4 Public Accounting Firms (KAP), which are considered to possess good competence, independence, and reputation. Within the framework of Agency Theory, Audit Quality functions as one of the external monitoring mechanisms used to mitigate agency conflicts. The presence of high-quality auditors can help monitor agent behavior, reduce information asymmetry, and ensure that non-financial disclosures, including ESG, align with reliable financial reporting quality and remain free from earnings management interventions

RESEARCH METHODOLOGY

Data and sample selection

This study employs secondary data collected from various sources, including company annual reports and the LSEG Refinitiv database. The population consists of non-financial companies listed on the Indonesia Stock Exchange (IDX) during the 2020–2024 period. The selection of the non-financial sector is based on the consideration that financial companies have significantly different asset structures and accounting regulations.

Through a purposive sampling method, the study identifies companies that meet specific criteria: continuously listed on the IDX, possessing an ESG score in the LSEG Refinitiv database, and not experiencing any trading suspension during the observation period. From an initial population of 827

companies, the sample elimination process resulted in 58 eligible companies. After excluding observations with missing data and outliers, the final sample consists of 238 firm-year observations over the 2020–2024 period.

Operational definition of variables

In this study, earnings management is quantified using the absolute value of Discretionary Accruals, following the modified Jones model established by Dechow et al. (1995).

The measurement of ESG performance is based on the composite ESG score obtained from the LSEG Refinitiv database. This score incorporates a comprehensive assessment of the company's environmental, social, and governance aspects, with higher scores reflecting a stronger commitment to sustainability and non-financial disclosure.

Audit quality serves as the moderating variable and is proxied by a dummy variable. A value of 1 is assigned if the company is audited by a Big 4 public accounting firm (Deloitte, EY, KPMG, or PwC), and 0 otherwise.

Additionally, several control variables are included in the analysis: (1) Firm Size (SIZE): Measured by the natural logarithm of total company assets. (2) Profitability (ROA): Measured by Return on Assets, calculated as net income after tax divided by total assets. (3) Leverage (DAR): Determined by dividing total liabilities by total assets (Debt to Asset Ratio). (4) Sales Growth (GROWTH): Calculated as the percentage change in sales from the previous year to the current year. (5) Loss (LOSS): A binary variable where a value of 1 is assigned if the company reports a loss (negative net income) in the current year, and 0 otherwise. (6) Operating Cash Flow (OCF): Calculated as the total cash from operating activities divided by the total assets of the previous year.

Model specification

The study employs two regression models for hypothesis testing using Moderated Regression Analysis (MRA). The first model tests the direct effect of ESG performance on corporate earnings management practices. Control variables, including SIZE, ROA, DAR, GROWTH, LOSS, and OCF, are included in the first model to control their effects on earnings management practices. The moderating variable, representing audit quality (BIG4), is included in the second model along with an interaction term to test its effect on the relationship between ESG performance and earnings management practices. The regression models are as follows:

Research Model 1:

$$EM = \alpha + \beta_1 ESG + \beta_2 SIZE + \beta_3 ROA + \beta_4 LEV + \beta_5 GROWTH + \beta_6 LOSS + \beta_7 OCF + \varepsilon_1$$

Research Model 2:

$$EM = \alpha + \beta_1 ESG + \beta_2 BIG4 + \beta_3 (ESG*BIG4) + \beta_4 SIZE + \beta_5 ROA + \beta_6 LEV + \beta_7 GROWTH + \beta_8 LOSS + \beta_9 OCF + \varepsilon_1$$

RESULTS AND DISCUSSION

Descriptive Statistics

Descriptive statistics display an overview of the research data, covering the mean, standard deviation, as well as minimum and maximum values.

Table 3. Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
EM	238	0.0465	0.0387	0.0002	0.1711
ESG	238	51.7526	17.5804	11.0800	88.0200
BIG4	238	0.7689	0.4224	0	1
SIZE	238	31.2513	1.0885	27.8965	33.7900
ROA	238	0.0735	0.0641	-0.1382	0.3020
DAR	238	0.4522	0.1975	0.0810	0.9366
GROWTH	238	0.0770	0.2211	-0.7393	0.8493
LOSS	238	0.0462	0.2104	0	1
OCF	238	0.1151	0.0853	-0.0506	0.4401

Source(s): Authors' own work

In general, the level of Earnings Management (EM) indicates variation across companies. The average ESG Performance of 51.7526, a minimum value of 11.0800, and a maximum value of 88.0200 show differences in environmental, social, and governance performance levels in the sample. The average Audit Quality (BIG4) is 0.7689, meaning approximately 76.89% of the sample was audited by Big 4 firms.

Model Estimation and Selection

The estimation model selection in this study was conducted through a series of panel data tests consisting of the Chow Test, Hausman Test, and Lagrange Multiplier (LM) Test. Initially, the Chow Test yielded a probability value of 0.0082 for Model 1 and 0.0074 for Model 2, indicating that the Fixed Effect model is superior to the Common Effect model. However, these results do not align with the Hausman Test, which showed probabilities of 0.2771 (Model 1) and 0.3845 (Model 2), directing the choice toward the Random Effect Model. This decision is reinforced by the Lagrange Multiplier Test, which produced values of 0.0306 for Model 1 and 0.0277 for Model 2, again supporting the use of the Random Effect Model (REM) as the most appropriate estimation model for this study.

Table 2 Model Estimation

	Chow Test	Hausman	LM	Selected Model
Model 1	0.0082	0.2771	0.0306	REM
Model 2	0.0074	0.3845	0.0277	REM

Source(s): Authors' own work

Tabel 3 Normality Test

Variable	Obs	Jarque-Bera	Probability
Model 1	238	41.8964	0.0000
Model 2	238	41.3848	0.0000

Source(s): Authors' own work

Classical Assumption Tests

Normality Test

To detect the normality of the regression residual distribution, this study relies on the normality test. According to Table 3, the Jarque-Bera statistics recorded a probability of 0.0000 for both Model 1 and Model 2. Since these results are less than the 0.05 tolerance value, this means the normality assumption cannot be fulfilled because the residual data of both models are not normally distributed. However, this condition does not seriously affect this study. Gujarati (2009) explains through the Central Limit Theorem that the sampling distribution will increasingly approach normal distribution when the number of observations used is sufficiently large. Because this study utilizes a sample size that exceeds the minimum requirement, the issue of non-normal residuals remains acceptable, meaning the regression model can still be used for hypothesis testing.

Multicollinearity

The test results provide correlation values between variables that are below 0.80. Thus, the research model is declared free from multicollinearity symptoms.

Tabel 3. Pearson's correlation matrix

	EM	ESG	BIG4	SIZE	ROA	DAR	GROWTH	LOSS	OCF
EM	1.0000								
ESG	-0.1377	1.0000							
BIG4	0.0399	0.3148	1.0000						
SIZE	-0.1535	0.3400	0.1164	1.0000					
ROA	0.1485	0.1489	0.1275	-0.2051	1.0000				
DAR	0.0950	-0.0551	0.0943	0.1369	-0.1881	1.0000			
GROWTH	0.1118	0.0769	0.0262	0.0171	0.2397	0.0977	1.0000		
LOSS	0.0748	0.0839	0.1207	0.0120	-0.3677	0.1523	-0.2030	1.0000	
OCF	0.1898	0.1594	0.2638	-0.1601	0.7549	-0.0211	0.0615	-0.1798	1.0000

Source(s): Authors' own work

Hypothesis Testing

Model 1 Hypothesis Testing

Based on the regression results in Table 4, the study simultaneously shows significant results. This is evident from the F-statistics having a probability of 0.0012 ($p < 0.05$). These findings demonstrate that the model is viable for describing the effects among the research variables. An Adjusted R^2 of 0.0702 is deemed adequate in

explaining Earnings Management (EM), with the remainder influenced by other variables. Based on partial results, Hypothesis 1 is accepted, indicated by its coefficient with a 5% significance level. Therefore, it is concluded that there is a negative and significant effect, where the better a company's ESG performance, the lower its earnings management practices.

Tabel 4Pengujian Hipotesis Model 1

EM	Coefficient	Std. Error	t-Statistic	Prob.
ESG	-0.0003	0.0001	-2.0855	0.0381
SIZE	-0.0023	0.0028	-0.8288	0.4081
ROA	0.0485	0.0693	0.6998	0.4848
DAR	0.0154	0.0142	1.0826	0.2801
GROWTH	0.0214	0.0116	1.8451	0.0663
LOSS	0.0318	0.0130	2.4426	0.0153
OCF	0.0734	0.0472	1.5542	0.1215
R^2	0.0977			
Adjusted R²	0.0702			
F-Statistics	3.5582			
Prob (F-Statistics)	0.0012			

Source(s): Authors' own work

Tabel 5. Pengujian Hipotesis Model 2

EM	Coefficient	Std. Error	t-Statistic	Prob.
ESG	-0.0002	0.0003	-0.6456	0.2153
BIG4	0.0098	0.0182	0.5419	0.5884
ESG_M	-0.0002	0.0003	-0.5241	0.6007
SIZE	-0.0023	0.0028	-0.8074	0.4203
ROA	0.0530	0.0703	0.7535	0.4519
DAR	0.0144	0.0145	0.9904	0.3230
GROWTH	0.0208	0.0118	1.7470	0.0820
LOSS	0.0325	0.0133	2.3387	0.0151
OCF	0.0738	0.0489	1.5055	0.1336
R^2	0.0980			
Adjusted R²	0.0624			
F-Statistics	2.7533			
Prob (F-Statistics)	0.0045			

Source(s): Authors' own work

Model 2 Hypothesis Testing

Table 5 shows that the panel data regression model tested simultaneously possesses a good level of significance, indicated by the F-statistic value of 2.7533 with a p-value of 0.0045 ($p < 0.05$). This result demonstrates that the study is good for testing the influence among variables. Meanwhile, the Adjusted R^2 value of 0.0624 means the model can explain 6.24% of the Earnings Management (EM) variation, while the remainder is explained by other factors. The interaction variable (ESG_M) has a coefficient of -0.0002 with a probability of 0.6007 (> 0.05), which implies that this variable does not have a significant effect; hence, Hypothesis 2 is rejected.

Discussion

The Effect of ESG Performance on Earnings Management

Based on the testing results in Model 1 presented in Table 4, the Environmental, Social, and Governance (ESG) variable is proven to have a negative effect on Earnings Management. This is reflected by the probability value of 0.0381, which falls below the 5% significance level, and the negative regression coefficient. This result indicates that an increase in ESG Performance is followed by a decrease in the level of Earnings Management. Thus, companies that are more consistent in applying ESG principles tend to produce financial reports that more accurately reflect actual conditions.

These findings can be explained through Stakeholder Theory, which views a company as an entity that must consider the interests of various parties involved in its business activities. Corporate efforts to maintain the trust of investors, creditors, customers, and society make corporate management tend to implement more responsible business practices. Under these conditions, the tendency to manipulate earnings becomes lower because such actions could damage corporate relationships with stakeholders.

The negative relationship between ESG and Earnings Management can also be understood through Agency Theory. Good ESG implementation is generally accompanied by increased information disclosure and corporate governance quality. Higher transparency allows the monitoring process by shareholders, regulators, and other external parties to take place more effectively. Consequently, the information gap between management and company owners becomes smaller, thereby restricting opportunities for Earnings Management. Furthermore, companies with good ESG Performance possess a reputation that needs maintaining, leading management to avoid actions that could lower corporate credibility, including financial statement manipulation.

These research results are consistent with findings from Primacintya and Kusuma (2025), Wu (2024), and Vatis et al. (2025), that companies with good ESG Performance tend to exhibit lower Earnings Management. These findings imply that ESG application is not only related to sustainability aspects but also plays a role in enhancing corporate financial reporting and accountability. Thus, Hypothesis 1 is accepted.

The Moderating Effect of Big 4 on ESG Performance and Earnings Management

The test results on Model 2 listed in Table 5 show that the interaction variable (ESG_BIG4) has a negative coefficient of -0.0002 with a significance value of 0.6007 (>0.05). This finding indicates that Big 4 firms have not been able to provide a moderating effect on the relationship between ESG Performance and Earnings Management. That is, the effect of ESG Performance on Earnings Management is

relatively the same for both companies audited by Big 4 firms and non-Big 4 firms.

According to Agency Theory, external auditors function as monitoring parties assisting in reducing information asymmetry between management and shareholders. In this context, Big 4 firms are generally perceived to have higher audit quality and are therefore expected to strengthen controls against Earnings Management practices. However, this study's results indicate that higher audit quality does not provide additional influence in strengthening the relationship between ESG Performance and Earnings Management.

This finding can be explained by the characteristics of ESG, which fundamentally drive companies to apply better transparency and accountability. According to Stakeholder Theory, companies with high ESG Performance tend to provide broader information to stakeholders as a form of corporate accountability. This condition can enhance supervision from various parties while simultaneously encouraging the company to preserve its reputation. As a result, the tendency to engage in Earnings Management becomes lower without having to rely on the moderating role of Audit Quality. Moreover, these results may also be influenced by the measurement of Audit Quality using Big 4 and non-Big 4 affiliation, which reflects the reputation of the public accounting firm more than the actual quality of audit execution. Therefore, a difference in auditor status does not necessarily result in differing capabilities to reinforce ESG's effect on Earnings Management.

The study's results differ from the findings of Yasmin et al. (2024), Le and Moore (2021), and Debnath et al. (2022), which found that Audit Quality could suppress Earnings Management practices. This discrepancy is likely caused by the different research models employed. In previous studies, Audit Quality was tested as a variable directly affecting Earnings Management, whereas in this study, Audit Quality is positioned as a moderating variable.

CONCLUSION

Based on the research findings, several conclusions are drawn. First, ESG Performance is proven to have a significant negative effect on Earnings Management practices, indicating that the better the ESG Performance, the smaller the company's tendency to engage in Earnings Management. Second, Audit Quality shows a different outcome as it is not proven to moderate the effect of ESG Performance on Earnings Management, implying that there is no significant difference concerning affiliation with Big 4 firms or otherwise.

Nevertheless, this study has several limitations, such as sample constraints due to the limited availability of ESG data scores from LSEG Refinitiv in Indonesia, thus not fully representing the entire population; the use of an Audit Quality proxy limited to Big 4 and non-Big 4 affiliation without considering audit fees, audit tenure, industry specialization, or auditor experience; and a model that has not incorporated other factors such as governance mechanisms, ownership structure, board characteristics, or corporate financial conditions. Therefore, it is recommended for future research to expand the observation period and sample scope, utilize more diverse Audit Quality proxies including auditors competent in sustainability report assurance, and test other governance mechanisms as moderators such as audit committee effectiveness, board of commissioners' characteristics, institutional ownership, or internal control quality. Meanwhile, for regulators, these results suggest the

importance of improving the quality and consistency of ESG disclosures as reliable indicators for assessing reporting quality, and for companies, it is advised to implement ESG substantively and integrate it with quality financial reporting practices to support transparency and accountability.

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