

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) PERFORMANCE AND EARNINGS MANAGEMENT: THE ROLE OF AUDIT QUALITY

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Abstract: Grounded in Agency and Stakeholder theories, this research explores the influence of Environmental, Social, and Governance (ESG) performance on earnings management, while also assessing whether audit quality serves as a moderating factor. The magnitude of earnings manipulation is evaluated using discretionary accruals. By applying a purposive sampling technique, the study analyzes 238 firm-year observations from non-financial corporations registered on the Indonesia Stock Exchange between 2020 and 2024. The data is processed utilizing Moderated Regression Analysis (MRA). The empirical outcomes reveal that organizations demonstrating superior ESG achievements are less likely to engage in earnings management. Conversely, audit quality, measured by the presence of a Big Four auditor, fails to show a significant moderating effect in reinforcing the linkage between ESG practices and reduced earnings manipulation.

Keywords: *Earnings Management, ESG, Audit Quality.*

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1. 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 earnings manipulation, a technique that leverages the permissiveness of accounting principles to shift the timing of when revenues and expenses are recorded, without directly altering 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 in 2021 (Reuters, 2021) as well as Under Armour in 2021 (U.S. Securities and Exchange Commission, 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) (IDX Channel, 2023), inventory recording issues at a subsidiary of PT Kimia Farma Tbk (2024) (CNBC Indonesia, 2023), and allegations of transaction engineering at PT Indofarma Tbk (2024) (CNBC Indonesia, n.d.) and eFishery (2024)(Kompas TV, 2025). These cases indicate that earnings

management remains a critical issue that can affect the reliability of financial disclosures and subsequent decision-making by investors.

In response to the increasing risk of financial reporting manipulation, corporate transparency has evolved beyond traditional financial reporting to encompass Environmental, Social, and Governance (ESG) disclosures, which have been mandated in Indonesia through OJK Regulation No. 51/POJK.03/2017. Viewed through the lens of Stakeholder Theory, firms demonstrating robust ESG initiatives are anticipated to display heightened transparency and accountability; consequently, this mitigates their motivation to manipulate earnings, driven by the need to preserve stakeholders' trust (Freeman, 1984; Jafar et al., 2024). Nevertheless, prior empirical findings remain inconclusive. Primacintya and Kusuma (2025) reported that superior ESG achievements are linked to a reduction in earnings management, whereas Almubarak et al. (2023) documented contrasting results, suggesting that ESG disclosure may also be strategically employed to enhance corporate reputation while concealing earnings manipulation practices. These inconsistent findings imply that ESG performance alone may not be sufficient to constrain managerial opportunism without the presence of effective external monitoring mechanisms (García-Sánchez et al., 2022). Although the interplay between ESG initiatives and earnings manipulation has attracted increasing academic attention, limited evidence has examined whether audit quality reinforces this relationship, especially within developing markets like Indonesia. Accordingly, the current research addresses this gap by exploring how audit quality functions to moderate the connection between ESG outcomes and earnings manipulation, utilizing a dataset of Indonesian non-financial enterprises from the years 2020 to 2024. By integrating audit quality within the nexus of ESG and earnings management, this research supplies further empirical insights into how independent external verification plays a part in amplifying the effectiveness of sustainability practices in promoting high-quality financial reporting. To capture the effectiveness of external monitoring, audit quality is proxied by affiliation with a Big Four audit firm (DeAngelo, 1981). Big Four auditors are generally recognized for their superior expertise, audit resources, and professional independence, enabling them to identify accrual-based earnings manipulation more effectively (Francis, 2004). Therefore, audit quality is expected to reinforce the ability of ESG performance to improve financial reporting transparency while reducing the likelihood that ESG disclosures are used primarily as an impression-management strategy.

2. Literature Review

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. Conflicts of interest, exacerbated by information asymmetry, drive managers to act in their own self-interest (Akerlof, 1970). This conflict is reinforced by the presence of information asymmetry, a condition where

management possesses more complete information compared to external parties. Classically, information asymmetry is rooted in the problems of adverse selection and moral hazard (Akerlof, 1970). 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. Based on stakeholder theory, the presentation of corporate information is not limited to financial statements. Stakeholders require broader information to assess the company's performance and accountability comprehensively. Environmental, Social, and Governance (ESG) disclosure serves as a means for companies to convey non-financial information regarding social, environmental, and corporate governance impacts (Alessa et al., 2024). The environmental aspect relates to managing the company's impact on the environment, such as energy use and emissions (Pompella & Costantino, 2023). The social aspect encompasses the company's relationships with employees, communities, and other parties, including labor practices and human rights (Ji et al., 2023; Pompella & Costantino, 2023). Meanwhile, the governance aspect focuses on internal control mechanisms, such as board structure, business ethics, and reporting transparency (Ji et al., 2023; Pompella & Costantino, 2023). 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.

ESG Performance and Earnings Management

ESG performance represents the extent to which a company integrates environmental, social, and corporate governance frameworks into its commercial activities while demonstrating transparency and accountability to its stakeholders. From the perspective of Agency Theory and Stakeholder Theory, elevated ESG performance can reduce information asymmetry and restrict managers' opportunities to participate in accrual-based earnings manipulation (Jensen & Meckling, 1976; Wong et al., 2023). Consistent with this view, prior empirical studies have documented that corporations exhibiting superior ESG outcomes typically demonstrate a reduced inclination toward manipulating financial figures (Liu et al., 2025; Primacintya & Kusuma, 2025; Saleh et al., 2025; Vatis et al., 2025). However, the greenwashing hypothesis suggests that managers might exploit ESG disclosures to strengthen corporate legitimacy and reputation while concealing manipulative accounting practices (Almubarak et al., 2023; Wu, 2024). Notwithstanding these competing perspectives, this study hypothesizes that when ESG initiatives are implemented substantively rather than symbolically, they have a greater tendency to restrict managerial discretion as well as enhance the credibility of disclosed financial profits.

H1: ESG Performance has a negative effect on Earnings Management.
ESG Performance, Audit Quality, and Earnings Management

Within the context of Agency Theory, high-caliber auditing functions as an external oversight instrument that enhances the trustworthiness of corporate fiscal reporting by limiting managers' ability to manipulate accounting information (Jensen & Meckling, 1976). Audit firms affiliated with the Big Four are widely considered to possess greater technical expertise, stronger professional independence, and more extensive audit resources, enabling them to identify accrual-based earnings manipulation with greater proficiency compared to their non-Big Four counterparts (Debnath et al., 2022; Le & Moore, 2021; Yasmin et al., 2024). Consequently, high-quality audits are expected to improve the dependability of a firm's financial accounts alongside its sustainability-oriented reports. When ESG information is subject to stronger external monitoring, the consistency between sustainability reporting and firms' actual performance is likely to increase, thereby reducing managerial incentives to use ESG disclosures as a means of masking opportunistic behavior (Almubarak et al., 2023; Wu, 2024). Therefore, this study proposes that audit quality strengthens the capacity of ESG initiatives to curb earnings management.

H2: Audit Quality strengthens the negative effect of ESG Performance on Earnings Management.

3. Research Method

This study adopts a quantitative research design using secondary data collected from firms' annual reports and ESG information obtained from the LSEG Refinitiv database. The analysis focuses on non-financial companies listed on the Indonesia Stock Exchange (IDX) over the 2020-2024 period. Financial institutions were excluded because they operate under different regulatory environments and financial reporting frameworks, which may reduce the comparability of the empirical results.

The sample was selected using purposive sampling. Firms were included if they (1) remained listed on the IDX throughout the observation period, (2) consistently disclosed ESG scores in the LSEG Refinitiv database, and (3) were not subject to trading suspension. Applying these criteria reduced the initial population of 827 firms to 58 eligible companies. After excluding outlier observations, the final dataset comprised 238 firm-year observations. The sample selection procedure is presented in Table 1.

The operational definitions and measurement of all research variables, including the dependent, independent, moderating, and control variables, are summarized in Table 2.

Hypothesis testing was performed using Moderated Regression Analysis (MRA). The baseline model examines the direct relationship between ESG Performance and Earnings Management while controlling for firm characteristics. The second model incorporates Audit Quality together with the interaction term between ESG Performance and Audit Quality to evaluate the proposed moderating effect. The regression models are specified as follows:

Research Model 1:

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

Research Model 2:

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

Table 1. Sample Selection process

Description	Total
Initial population of non-financial companies listed on the IDX (2020–2024)	827
(-) Companies excluded due to criteria mismatch (new IPOs, missing ESG data, trading suspensions)	769
Total eligible companies	58
Total initial firm-year observations (58×5)	290
(-) Observations identified as outliers	52
Final valid firm-year observations	238
Source(s): Authors' own work	

Table 2. Operational Definition

Variable	Measurement
EM	Absolute value of discretionary accruals based on modified Jones Model (Dechow et al., 1995).
ESG	Composite ESG score sourced from the LSEG Refinitiv database.
BIG4	A binary variable taking the value 1 if the company is audited by a Big 4 public accounting firm, otherwise 0 (Alharasis et al., 2025).
SIZE	The natural logarithm of total company assets (Primacintya & Kusuma, 2025).
ROA	Ratio of net income after tax divided by total assets (Vatis et al., 2025).
LEV	Ratio of total liabilities divided by total assets (Vatis et al., 2025).
GROWTH	Percentage change in sales from the previous year to the current year (Nguyen et al., 2024).
LOSS	A binary variable taking the value 1 if the company has a loss or negative net income, otherwise 0 (Primacintya & Kusuma, 2025).
OCF	Ratio of total cash from operating activities divided by total assets of the previous year (Almubarak et al., 2023).
Source(s): Authors' own work	

4. Results and Discussion

4.1. Results

Descriptive Statistics

The summary of the dataset is presented through descriptive statistics, which outline the central tendencies and dispersions specifically the mean, standard deviation, and the extreme bounds (minimum and maximum) of the variables.

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

The analytical summary highlights notable fluctuations in earnings management (EM) across the evaluated corporations, reflecting diverse approaches to financial reporting. Additionally, the ESG Performance metric exhibits an average score of 51.7526 within a spectrum of 11.0800 to 88.0200, pointing to a wide divergence in how these entities integrate environmental, social, and governance frameworks. Moreover, the audit quality variable (BIG4) yields an average of 0.7689, demonstrating that approximately 76.89% of the total firm-year observations involved engagements with Big Four accounting firms.

Model Estimation and Selection

Table 4. 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

To determine the most fitting panel data approach, a series of diagnostic evaluations was conducted, encompassing the Chow, Hausman, and Lagrange Multiplier (LM) procedures. The initial Chow test yielded probabilities of 0.0082 and 0.0074 for the first and second models, respectively, thereby favoring the Fixed Effects Model over the Common Effects alternative. Conversely, the subsequent Hausman evaluation resulted in probabilities of 0.2771 (Model 1) and 0.3845 (Model 2), which directed the preference toward the Random Effects Model rather than the Fixed Effects approach. This conclusion was reinforced by the LM test outcomes, showing significance levels of 0.0306 and 0.0277 for the respective models. Consequently, the collective diagnostic evidence confirms that the Random Effects Model (REM) serves as the optimal framework for conducting the regression analyses in this research.

Classical Assumption Tests

Normality Test

To detect the normality of the regression residual distribution, this study relies on the normality test. According to Table 5, 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.

Table 5. 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			

Multicollinearity

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

Table 6. 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

Table 7. Model 1 Hypothesis Testing

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 R ²		0.0702		
F-Statistics		3.5582		
Prob (F-Statistics)		0.0012		
Source(s): Authors' own work				

Based on the regression results in Table 7, 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 R² 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.

Model 2 Hypothesis Testing

Table 8 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 R² 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.

Table 8. Model 2 Hypothesis Testing

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 R ²	0.0624			
F-Statistics	2.7533			
Prob (F-Statistics)	0.0045			
Source(s): Authors' own work				

4.2. Discussion

The Effect of ESG Performance on Earnings Management

The statistical outcomes derived from Model 1 (Table 7) confirm a significant inverse linkage between ESG achievements and the practice of earnings management ($p = 0.0381$). This inverse coefficient demonstrates that organizations demonstrating superior ESG capabilities are correspondingly less prone to manipulating their financial results. Such evidence implies that a robust dedication to environmental, social, and governance standards effectively curbs the motivation of executives to exploit accounting loopholes, ultimately elevating the integrity of financial disclosures. Consequently, companies that consistently implement ESG principles are more likely to produce financial statements that faithfully represent their underlying economic performance.

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 become lower because such actions could damage corporate relationships with stakeholders.

The inverse dynamic observed between ESG initiatives and earnings manipulation can similarly be rationalized from the perspective of 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), Saleh et al. (2025), Vatis et al. (2025), serta Liu 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 Four on ESG Performance and Earnings Management

Based on the statistical output from Model 2 (Table 8), the cross-product of ESG metrics and the auditor proxy ($ESG \times BIG4$) fails to reach statistical significance ($p = 0.6007$). Consequently, the empirical evidence rejects the proposition that superior audit oversight amplifies the deterrent effect of sustainability practices on financial manipulation. This implies that a firm's success in curbing opportunistic accounting through ESG commitments remains relatively consistent, irrespective of their engagement with either Big Four or non-Big Four accounting firms.

Viewed through the lens of Agency Theory, independent auditors act as external overseers designed to mitigate information gaps and deter executives from engaging in self-serving practices (Jensen & Meckling, 1976). Even though industry leaders like the Big Four are widely presumed to deliver superior assurance services due to their vast resources, extensive skill sets, and stringent independence, the current analysis indicates that such premium auditing traits do not substantially augment the capacity of ESG initiatives to suppress earnings manipulation.

One possible explanation is that companies with stronger ESG performance have already established governance practices and transparency mechanisms that reduce managerial discretion independently of external audit quality. By committing to comprehensive sustainability reporting and heightened stakeholder responsibility, such organizations naturally attract stricter surveillance from regulatory bodies, market participants, and the public. As a result, the internal adoption of robust ESG frameworks operates as a standalone governance tool, which ultimately weakens the added value of external audit quality in deterring financial reporting biases.

Another explanation relates to the proxy used to measure audit quality. Within this research framework, the caliber of an audit is exclusively determined by a firm's partnership with a Big Four entity. Although utilizing auditor scale as an indicator is common practice, it predominantly captures the firm's market prestige rather than the practical thoroughness of the audit procedures performed. Because variations in assurance efficacy can occur across both top-tier and lower-tier accounting firms, relying purely on brand affiliation might fail to accurately represent true audit proficiency. Hence, the specific metric utilized here might obscure the actual moderating dynamics of audit quality.

These empirical outcomes diverge from prior literature documented by Yasmin et al. (2024), Le and Moore (2021), and Debnath et al. (2022), wherein elevated audit standards were shown to directly mitigate financial statement manipulation. This discrepancy can largely be traced back to methodological variations. While earlier investigations treated audit quality primarily as a standalone predictor exerting a direct impact on accrual manipulation, the current research model positions it as an interacting factor designed to modify the association between sustainability outcomes and accounting discretion. Because the structural

frameworks of these studies test distinctly different theoretical pathways, their conclusions cannot be directly equated.

5. Conclusion

This study arrives at two principal conclusions. First, superior ESG outcomes are linked to a reduction in earnings management practices, indicating that companies demonstrating greater commitment to environmental, social, as well as governance practices are less likely to manipulate reported financial results. Furthermore, the analytical findings fail to validate the proposition that Audit Quality moderates the relationship between ESG Performance and Earnings Management. As a result, the capacity of ESG Performance in constraining Earnings Management appears to be comparable regardless of the auditor's tier, be it a Big Four entity or an alternative accounting firm.

Nevertheless, the current research acknowledges certain boundaries, particularly regarding sample constraints due to the limited access to comprehensive ESG metrics provided by LSEG Refinitiv within the Indonesian market, thereby not fully representing the entire population; the use of an Audit Quality proxy limited to top-tier versus lower-tier firm affiliation without considering engagement duration, audit remuneration, industry specialization, or auditor experience; and a model that has not incorporated other factors such as governance mechanisms, ownership frameworks, board characteristics, or corporate financial conditions. Therefore, it is recommended that upcoming investigations broaden the timeframe of analysis as well as the sample scope, utilize a broader range of 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 enhancing the reliability and uniformity of ESG reporting to serve 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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