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ESG, audit quality, and political connections on firm value: The mediating role of leverage and profitability

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ABSTRACT

This study investigates the impact of environmental, social, and governance (ESG) practices, audit quality, and political ties on firm value, with leverage and profitability as mediators. Using data from 18 ESG Leader firms (2021–2024) and analyzed through Structural Equation Modeling (SEM) with SmartPLS 4, the research explores both direct and indirect effects. Results show ESG and audit quality do not directly affect firm value but become significant when mediated by leverage and profitability. Political connections negatively influence firm value directly but exert a positive effect indirectly through financial performance. Leverage and profitability emerge as key mediators, explaining much of the variation in firm value and underscoring the role of financial mechanisms in transmitting non-financial factors. The study contributes originality by integrating governance, audit quality, and political connections with financial performance offer a more comprehensive interpretation of firm value.

Introduction

Stakeholders and investors often rely on firm value as a fundamental indicator that reflects the market's assessment of a company's financial potential and stability, helping them evaluate the business's long-term prospects, including its growth potential and financial resilience (Wahyono et al., 2024). In the long run, companies that adopt sustainability practices tend to achieve stronger financial performance, enabling them not only to survive but also to continue expanding (Benali, 2025). Because shareholder welfare increases in line with the rise in firm value, shareholders naturally expect the company's value to grow (Suteja et al., 2023). For this reason, many stakeholders place considerable attention on firm value, especially regarding potential conflicts of interest between management and shareholders (Moez, 2024).

One way to define firm value is the price level that potential investors consider reasonable when assessing whether a business is worth investing in (Harjanto, 2024). Investors' evaluations of company performance are closely linked to capital market discussions on how profitability influences firm value (Asni & Agustia, 2022). The adoption of sustainable finance is expected to help maintain and enhance both profitability and firm value (Dinarjito, 2024). When making investment decisions, investors prioritize financial performance (Budi & Gusni, 2024) as profitability contributes positively to stock prices (Komariah & Riantani, 2024). Therefore, firm value reflects investor confidence and the strength of the relationship between a company's internal and external stakeholders.

In its development, firm value is also shaped by non-financial factors, one of which is environmental, social, and governance (ESG) performance. Companies that adopt ESG practices gain a competitive advantage that can enhance their firm value (Cakranegara & Sidjabat, 2021). ESG has also become an essential component of long-term investment decisions (Edmans, 2023), as it aligns market opportunities with social expectations and regulatory policies (D'Costa et al., 2025). Through third-party verifiable disclosures (Gipper et al., 2025), ESG strengthens transparency and accountability while supporting improvements in financial performance (Candio, 2024; Rau & Yu, 2024).

Audit quality, alongside ESG, is also a crucial factor in shaping firm value. Audit quality reflects the extent to which a company's financial information can be considered reliable. External audits help protect investors from managerial actions that may involve information asymmetry and excessive agency costs (Diab & Eissa, 2024). Consequently, strong audit quality enhances the positive effects of ESG on firm value (Qadeer et al., 2025). A high-quality audit not only improves the credibility of financial statements (Suranta et al., 2025) but also promotes better corporate compliance with tax obligations (Kartadjumena & Nuryaman, 2024), ultimately reinforcing firm value.

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On the other hand, political connections continue to play a significant role in shaping firm value, particularly in state-owned enterprises and long-established companies (Chu et al., 2025). Such connections can provide firms with privileged access to financing and various government facilities (Li & Wang, 2024). Nevertheless, political ties may also undermine governance mechanisms, for instance by reducing the effectiveness of independent directors' oversight functions (Hamdi, 2024). Moreover, CSR initiatives can be strategically leveraged to cultivate political relationships while expanding operations into key economic sectors (Zhang et al., 2024). Therefore, political connections present a dual effect: they can enhance financial opportunities but simultaneously introduce governance risks that may influence firm value.

Moreover, internal elements such as leverage and profitability play a crucial role in shaping firm value. Profitability reflects a company's ability to generate earnings and serves as a key indicator of its sustainability within a dynamic business environment (Yeye & Egbunike, 2023). Meanwhile, leverage illustrates the company's financing structure, which can influence both risk exposure and potential returns (Asni & Agustia, 2022). These two factors may also act as mediators that connect the effects of ESG, audit quality, and political connections to firm value, as both are closely linked to financial performance an aspect that investors consistently prioritize.

Investors are increasingly recognizing that firm value is shaped not only by financial figures but also by non-financial factors such as ESG practices, audit quality, and political connections (Aydoğmuş et al., 2022; Crane & Koch, 2025; Nguyen & Nguyen, 2024). These non-financial factors function as signals of governance quality, transparency, and the firm's long-term sustainability prospects, which the market interprets through their linkages to the firm's economic conditions as reflected in financial statements (De La Fuente & Velasco, 2025). Consistent with sustainability theory, strong ESG performance and governance are viewed as components of long-term value creation and risk management strategies; therefore, their effects are conceptually expected to materialize first in profitability and the cost of capital or financing structure, before being capitalized into firm value (Fang & Guo, 2025). Accordingly, leverage and profitability serve as key channels that clarify how non-financial signals are translated into expectations about future cash flows and risk or cost-of-capital, which ultimately shape firm value. Employing a quantitative design with Partial Least Squares–Structural Equation Modeling (PLS-SEM) in SmartPLS 4, this study enables the assessment of a complex latent-variable model and captures multiple mediating relationships within a single, integrated framework.

However, empirical findings regarding the complex relationships between these variables still show mixed results. The diversity of results in earlier research indicates the presence of a research gap that warrants further examination. We refined and adjusted the research model to re-evaluate the relationships among the variables in a more systematic and contextual manner. This approach is expected to provide more consistent empirical insights and contribute meaningfully to the development of the financial literature. Therefore, this study seeks to make a new contribution by integrating non-financial factors (ESG, audit quality, political connections) and financial factors (profitability, leverage) to explain firm value.

Literature Review

Signaling Theory

Signaling theory, introduced by Spence (1973), explains how firms reduce information asymmetry by sending credible signals to stakeholders about their quality, risk profile, and long-term prospects. In corporate finance, such signals play a vital role in shaping investor perceptions and lowering uncertainty (Colombo, 2021). ESG disclosures, strong audit quality, and political connections serve as positive signals that reflect managerial transparency, accountability, and institutional strength. These signals help reduce perceived risk and enhance the firm's reputation among investors and creditors.

With respect to the mediating variables, positive signals also influence a firm's leverage and profitability. Transparent ESG performance and high audit quality reduce perceived credit risk, prompting creditors to offer financing under more favorable terms. This improves the firm's access to external capital and affects leverage decisions. Similarly, strong signals foster customer trust and investor confidence, supporting market expansion and operational efficiency, which in turn increase profitability. Enhanced leverage and profitability then amplify the signaling effects and ultimately contribute to higher firm value.

Sustainability Theory

Sustainability theory, rooted in the Brundtland Report (1987) and supported by stakeholder theory (Freeman, 1984), states that firms must balance environmental, social, and economic dimensions to ensure long-term viability. This principle is further emphasized by Elkington (1994) Triple Bottom Line concept, which highlights that sustainability-oriented practices generate long-term value for companies and their stakeholders.

The adoption of ESG practices influences the mediating variables through several mechanisms. Environmentally efficient operations reduce waste, resource usage, and regulatory risks, thereby strengthening

profitability through cost savings and improved operational effectiveness. Social responsibility initiatives enhance customer loyalty and employee productivity, ultimately contributing to higher profit margins. Strong ESG performance also lowers lenders' risk perceptions, enabling firms to secure financing under more favorable conditions, which directly affects leverage decisions. Through improved profitability and more optimal leverage structures, sustainability-driven firms are better positioned to enhance their overall firm value.

Legitimacy Theory

Legitimacy theory (Dowling & Pfeffer, 1975) posits that organizations seek to align their activities with societal expectations to preserve legitimacy and maintain their social license to operate. ESG disclosures function as a channel through which firms demonstrate adherence to prevailing social norms, while high audit quality signals regulatory compliance and financial credibility. Political connections may further strengthen legitimacy by indicating institutional support and reducing regulatory uncertainty.

Legitimacy fosters stakeholder trust, which directly shapes both leverage and profitability. When a firm is perceived as credible and responsible, creditors tend to view it as a lower-risk borrower, enabling access to more affordable and stable debt financing—thus influencing leverage decisions. Legitimacy also enhances market acceptance and consumer confidence, which in turn boosts demand and improves profitability. As leverage becomes more efficiently managed and profitability rises, these legitimacy-driven advantages ultimately contribute to greater firm value.

Agency Theory

Agency theory (Jensen et al., 1976) explains that conflicts of interest arise between managers and shareholders due to information asymmetry and divergent objectives. ESG practices and high audit quality function as governance mechanisms that help reduce agency costs by enhancing transparency, limiting managerial opportunism, and strengthening monitoring processes. Political connections, depending on their nature, may alleviate agency issues by providing access to valuable information or exacerbate them through rent-seeking behavior.

Leverage and profitability are closely linked to agency mechanisms. Debt serves as a disciplinary instrument that constrains managerial discretion through repayment obligations, thereby aligning managerial actions with shareholders' interests. Firms with stronger ESG performance and higher audit quality generally experience lower agency risk, enabling them to optimize leverage without incurring excessive monitoring costs. Reduced agency costs also foster higher profitability, as resources are allocated more efficiently and managerial decisions become more value-enhancing. Ultimately, lower agency costs reflected through improved leverage management and stronger profitability contribute to greater firm value.

Resource Dependency Theory

Resource dependency theory (Pfeffer & Salancik, 1978), argues that firms rely on external actors to obtain essential resources such as capital, regulatory support, information, and market legitimacy. To secure these critical resources, companies adopt various strategies, including strengthening ESG performance, ensuring high audit quality, and drawing on political connections.

These external dependencies are closely associated with the mediating variables in the model. Strong ESG performance and credible audit quality enhance lenders' trust and lower perceived risk, thereby improving access to external financing and shaping leverage decisions. Political connections may further facilitate access to loans, credit guarantees, or more flexible regulatory environments, allowing firms to manage leverage more strategically. Access to key external resources also supports higher profitability by enabling firms to invest in efficiency improvements, capture new market opportunities, and reduce operational risks. As leverage and profitability increase, the firm's resource base becomes more robust, decreasing uncertainty and ultimately contributing to greater firm value.

Hypothesis Development

ESG can be a competitive and sustainable advantage that can make companies more able to attract external financing, including debt for expansion. ESG can influence leverage because strong ESG performance increases a firm's credibility and reduces lenders' risk perception. This makes creditors more willing to provide financing, allowing firms to access debt more easily and at better terms. As a result, ESG supports a healthier and more efficient leverage structure.

The findings of previous studies reinforce this mechanism. For instance, creditors and investors tend to believe that firms with strong ESG profiles are more likely to receive easier access to long-term debt (Li et al., 2024). In addition, enhanced reputation and transparency through ESG reduce the likelihood of leverage manipulation and strengthen the positive effects of leverage when used prudently (Shan & Zhu, 2024). ESG also

serves as an important foundation for reputation and financing access, enabling firms to maintain strategically sound leverage positions (Qu & Mo, 2024). Building on this, ESG practices can significantly shape a firm's capital structure and accelerate the adjustment process toward its target leverage ratio (Chen, 2024).
H_1: ESG has a favorable impact on leverage.

Companies with strong ESG performance tend to show higher profitability because responsible environmental and social practices reduce operational risks, improve efficiency, and strengthen customer and investor trust. High ESG standards also enhance a firm's reputation, attract stable investment, and support long-term operational stability, all of which contribute to stronger financial outcomes.

As a result of strong ESG implementation, firms tend to experience higher profitability (Hari Purnomo et al., 2024). This aligns with findings indicating that ESG has a significant and positive effect on financial performance, particularly when measured by (Khairunnisa & Widiastuty, 2023; Zahroh & Hersugondo, 2021). Companies that consistently maintain high ESG standards generally demonstrate better financial outcomes, reflected in increased ROE and ROA (Marie et al., 2024). Moreover, high firm value combined with effective ESG practices further contributes to improved profitability (Budi & Gusni, 2025), while the overall level of ESG disclosure is positively and significantly correlated with the company's financial performance (Chung et al., 2024). Overall, there exists a strong and meaningful relationship between ESG initiatives and financial performance indicators (Saha & Khan, 2024). These empirical results support legitimacy theory, stakeholder theory, and signaling theory, indicating that ESG reporting has a statistically significant positive impact on profitability (Treepongkaruna & Suttipun, 2024).
H_2: ESG has a favorable impact on profitability.

Tobin's Q measures how the market values a firm relative to the replacement cost of its assets (Tobin, 1969). Firms with higher Tobin's Q are typically viewed as being priced above the replacement cost of their assets, reflecting investor optimism about future returns. ESG practices can enhance this market valuation because they signal responsible management, lower risk exposure, and stronger long-term growth prospects. Firms with strong ESG performance typically face fewer regulatory issues, attract socially conscious investors, and foster trust among stakeholders all of which contribute to increased market confidence and improved valuation.

Empirical evidence consistently supports this rationale. Previous studies have shown that social, governance, and disclosure practices positively influence company value as proxied by Tobin's Q (Minggu et al., 2023). Similiarly Zhang et al. (2020) found that the disclosure of social and environmental information has a favorable effect on Tobin's Q. Research conducted in China indicates ESG performance has a significant and positive impact on Tobin's Q in both eastern and western regions (Wu et al., 2022). In addition, social and governance performance positively affect firm value as measured by the price-to-book ratio (Sholekha & Astuti, 2024), and the combined effect of ESG and firm value shows a strong positive correlation (Yu & Xiao, 2022). Audit committee performance alongside ESG also exerts a significant positive impact on firm value based on Tobin's Q (Samy El-Deeb et al., 2023; Septiani & Munandar, 2025). Furthermore, ESG disclosure scores are significantly and positively associated with Tobin's Q, indicating that higher scores correspond to higher firm value (Mahmood et al., 2025). Other studies suggest that ESG has a positive and nonlinear effect on corporate value (Rastogi et al., 2024). According to Ngamtampong and Sukprasert (2025) strong ESG performance significantly enhances firm value, demonstrating that sustainable practices foster long-term financial success.
H_3: ESG has a favorable impact on firm value.

High-quality audits enhance the transparency of financial statements, thereby reducing uncertainty for creditors. This increased transparency makes the firm more trustworthy and facilitates easier access to loans. Audit quality also supports better financial performance, and firms can utilize short-term debt to improve financial efficiency (Nguyen, 2024). Research indicates that audit quality is positively associated with real earnings management in companies with relatively high leverage and low cash flow (Le, 2025). Furthermore, Abdullah et al. (2025) found that factors such as the size of the public accounting firm, issuance of qualified audit opinions, audit fees, corporate leverage, and Audit Report Lag (ARL) are all significantly positively correlated with audit quality. According to Zadeh (2025), a client firm's trade credit policies can also be influenced by audit quality. Overall, high-quality audits reduce information asymmetry and lower perceived risk for lenders, making creditors more willing to provide financing, which in turn affects the firm's leverage structure.
H_4: Audit quality has a favorable impact on leverage.

The primary role of external audits is to enhance the quality of a company's accounting information (Wu & Li, 2025). This is often achieved by highlighting the significant risks faced by management through Key Audit Matters (KAM) (Al Qahtani et al., 2025). Companies with strong ESG performance tend to be more ethically driven and motivated to engage one of the Big Four auditors to ensure higher audit quality (Diab & Eissa, 2024). To

accomplish this, management typically allocates additional resources, such as hiring auditors with specialized industry expertise or paying higher audit fees (Moalla & Dammak, 2023). High-quality audits, in turn, can enhance profitability because accurate and transparent financial reporting improves managerial decision-making, strengthens stakeholder trust, and reduces the risk of financial misstatements. Together, these factors support more efficient operations and stronger overall financial performance.
H_5: Audit quality has a favorable impact on profitability.

Audit quality can influence firm value because high-quality auditors provide more reliable, transparent, and independently verified financial information. Their stronger expertise and monitoring ability reduce earnings management and information asymmetry, thereby increasing investor confidence and improving market assessment of the firm's long-term prospects. As a result, companies audited by reputable and competent auditors tend to receive higher market valuations.

High-quality auditors, particularly those affiliated with the Big Four, possess deep expertise, strong monitoring capabilities, and high credibility, which enhance the reliability of financial reporting (Jiang et al., 2019). Larger public accounting firms are often able to provide more comprehensive disclosures (Alhazmi et al., 2024), and their strong international reputation fosters greater confidence in a company's financial statements (DeAngelo, 1981). However, corporate governance practices continue to influence the performance of public accounting firms (Almuzaiqer et al., 2025), while the quality of external auditors significantly affects a company's CSR disclosures (Kolsi et al., 2022). Consequently, high-quality external audits can reduce earnings management and misstatements, thereby improving the overall quality of financial reporting (Nguyen, 2024). Multiple studies have also found a significant positive relationship between external audits and Tobin's Q (Al-ahdal & Hashim, 2022; Kalita & Tiwari, 2023; Samy El-Deeb et al., 2023). From an agency theory perspective (Kassem, 2024), external auditors play a critical role in enforcing accountability, as business audits serve as a key mechanism to prevent agency conflicts (Jensen et al., 1976). Thus, the presence of high-quality audits provides a clear signal to investors and other stakeholders regarding a firm's viability and value, especially when auditors' independence may be constrained by agency issues (Kalia et al., 2023).
H_6: Audit quality has a favorable impact on firm value.

Political connections occur when a company maintains relationships with political or government actors, either directly or indirectly, providing strategic advantages such as preferential access to credit facilities (Awlia Az'ari & Lastiati, 2022). Through these connections, companies can defer debt and interest payments, including short-term obligations to creditors and suppliers, while also obtaining additional government loans. Moreover, firms may reduce reliance on costly long-term bank loans by opting for unsecured short-term borrowing (Chen et al., 2025). Political ties also offer benefits to taxpayers, such as easier access to loans and lower-risk tax audits (Hajriati et al., 2024). Taken together, these advantages lower lenders' perceived risk and strengthen the company's position in credit markets, enabling greater debt access and encouraging strategic use of leverage.
H_7: Political connections have a favorable impact on leverage.

According to the Financial Services Authority (OJK), political connections are relationships established between certain parties and individuals with political interests who share common goals, providing mutual benefits. Companies often leverage political connections to facilitate interactions with the government (Faccio, 2006). Through these connections, firms can gain privileges that support their business continuity (Nugrahanti & Nurfitri, 2022). Companies with extensive political ties typically enjoy easier access to regulatory systems and critical resources (Marie et al., 2024). Furthermore, political connections can mitigate the negative effects of high leverage on a company's investment and earnings (Li et al., 2023). Altogether, these advantages enhance operational stability, reduce institutional barriers, and enable firms to pursue opportunities that strengthen overall profitability.
H_8. Political connections have a favorable impact on profitability.

Political connections can influence firm value because firms with close ties to government officials often gain preferential access to resources, including lower lending rates, regulatory support, and external financing. These advantages reduce operational uncertainty and strengthen the firm's competitive position, which in turn increases market confidence and enhances firm valuation. From an agency theory perspective, political ties may also function as an additional monitoring mechanism, encouraging politically connected executives to maintain reputational credibility. Empirical evidence further shows that politically connected firms tend to improve disclosure practices such as ESG reporting thus reducing information asymmetry and reinforcing investor trust. Together, these effects position political connections as a strategic asset that can positively affect firm value.

According to crony capitalism theory, business success often relies on strong political connections with government officials. These ties not only enable firms to better monitor their operations but also provide access to lower borrowing costs and easier external financing, in line with agency theory (Septiani & Munandar, 2025). CEOs

with political connections are generally more motivated to protect their reputations and maintain political legitimacy (Marie et al., 2024), while politically connected audit committees tend to be more proactive in disclosing ESG-related issues (Astuti, 2024). In this way, political connections create an environment that supports the company's strategic objectives, enhances its competitive advantage, and reinforces investor confidence in the firm's value (Sholekha & Astuti, 2024).
H_9: Political connections have a favorable impact on firm value.

According to Durand (1952), in the net income approach, a firm's value tends to increase when leverage is used moderately, but it may decline if leverage becomes excessive due to higher financial risks and potential bankruptcy. The level of leverage a company maintains clearly affects its value (Margono & Gantino, 2021). Leverage, measured as the proportion of long-term debt to total assets, reflects the extent to which a firm relies on debt financing (Alsaadi, 2025) and indicates the size of the repayment obligations it must bear (Margono & Gantino, 2021). Excessive leverage can create uncertainty for investors, raising concerns about investment decisions (Bon & Hartoko, 2022), because higher leverage increases the likelihood of default or bankruptcy (Kusumaningrum & Nahda, 2022). However, studies by Dewi & Soedaryono (2023); Timotius & Setiawan. R (2023) show that, when used judiciously, leverage can actually enhance firm value. This is because prudent debt usage can expand operational capacity, signal management confidence in future cash flows, and optimize tax benefits from interest payments. When effectively managed, leverage not only strengthens the company's financial structure but also contributes to value creation.
H_{10}: Leverage has a favorable impact on firm value.

Profitability is a key performance indicator that reflects a firm's ability to generate earnings from its operations (Gusni et al., 2025.) and serves as a measure of operational efficiency (Bon & Hartoko, 2022). A higher level of profitability signals that a company is effectively managing its resources, which in turn can enhance its overall market value. One commonly used metric for measuring profitability is Return on Equity (ROE), which represents the ratio of net profit to total shareholder equity (Ronoowah & Seetanah, 2023). Shareholder equity reflects the ownership interests of investors in the company (Arhinful & Radmehr, 2023), and the firm's market value is strongly influenced by how well it generates returns relative to these investments (Alathamneh et al., 2025). Moreover, firms with strong ESG performance tend to see improved associations between short-term debt and profitability metrics such as ROA and ROE (Alhajjeah et al., 2025). ROE, in particular, is a critical indicator for assessing the firm's ability to sustain operations over the long term (Lee & Tahmoush, 2025). Overall, higher profitability not only strengthens investor confidence but also signals managerial effectiveness and provides additional capacity for reinvestment in growth opportunities, thereby contributing positively to firm value.
H_{11}: Profitability has a favorable impact on firm value.

This hypothesis posits that leverage can act as a mediator between ESG, audit quality, and political connections and their impact on firm value. Previous studies have not specifically examined whether leverage mediates the relationship between ESG, audit quality, and political connections and firm value. However, research has explored the role of leverage as a mediator in other conditions. For instance, Huynh et al (2022) showed that financial leverage partially mediates the effects of board independence and board size on firm performance. Similarly, higher leverage can serve as a positive mediator for financial performance and governance compliance (Shakri et al., 2025), and financial leverage mediates the link between corporate governance and firm performance (Kijkasiwat et al., 2022). In addition, leverage has been shown to mediate the relationship between IFRS compliance and board size (Amanamah, 2024). Leverage functions as a mediator because it reflects the firm's financial structure in response to internal and external governance factors, translating these influences into changes in risk, capital allocation, and ultimately firm value. Through this mechanism, leverage serves as an intermediary channel through which ESG practices, audit quality, and political connections exert their economic effects on firm value.
H_{12}: Leverage mediates the connection for ESG and firm value.
H_{13}: Leverage mediates the connection for audit quality and firm value.
H_{14}: Leverage mediates the connection for political connections and firm value.

To test for mediation, it is necessary to determine whether a mediating variable can clarify or strengthen the relationship between the independent and dependent variables (ROE) (Baron & Kenny, 1986). According to this framework, the relationship between ESG, audit quality, and political connections with firm value can also be mediated by profitability. Research by Wu et al. (2025) indicates that the link between a company's sustainability initiatives and the disclosure of environmental information is mediated by profitability. Similarly, (Asni & Agustia, 2022) demonstrate that financial performance, particularly ROA and ROE, serves as a pivotal mechanism in conditioning the association between firm value and green innovation. Profitability also functions as a mediator between physical assets and market valuation, as measured by Tobin's Q (Alathamneh et al., 2025). Furthermore, Rusmana and Sembiring (2025) find

that firm value is positively influenced by financial performance, which can also serve as a mediating channel for the effects of social performance and governance on firm value. Profitability operates as a mediator because it reflects the firm's ability to translate governance practices, sustainability initiatives, and political advantages into enhanced financial outcomes. Improved profitability subsequently boosts market confidence and valuation, thereby transmitting the impact of ESG, audit quality, and political connections to firm value. Figure 1 shows the research conceptual framework of the study.

H_{15}: Profitability mediates the connection for ESG and firm value.
H_{16}: Profitability mediates the connection for audit quality and firm value.
H_{17}: Profitability mediates the connection for political connections and firm value.

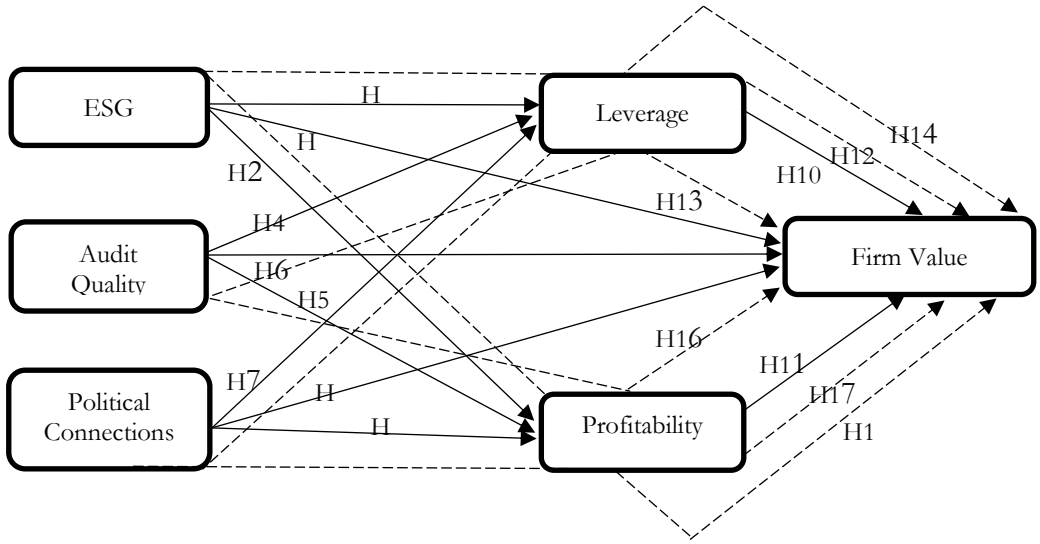

Figure 1. Research Conceptual Framework
Source: 2025 data processing

Research Method

With leverage and profitability serving as mediating variables, this study employs an explanatory design and a quantitative approach to examine the cause-and-effect relationships among ESG indicators, audit quality, political connections, and firm value. This approach was chosen because it allows for the analysis of complex interactions within a single integrated model, capturing both direct and indirect effects among latent variables. Data for the study were collected from the companies' annual reports, sustainability reports, and financial statements. The analysis was conducted using Partial Least Squares–Structural Equation Modeling (PLS-SEM) through SmartPLS 4 software, which is well-suited for small sample sizes, complex models, and does not require strict assumptions about the underlying data (Hair et al., 2017). The research population consists of all companies recognized as ESG leaders from 2021 to 2024, and purposive sampling was applied to select the study sample, as detailed Table 1. The Operationalization of Variables used in this study is presented in Table 2.

Table 1. Population and Sample Data

No	Population	Total
1	List of Companies listed on IDX ESG Leaders (population)	30
2	Companies that survived in the IDX ESG Leaders 2021-2024 (sample)	18
3	Total research observations in 2021-2024 (18 companies x 4 years)	72

Source: 2025 data processing

Table 2. Variable Operationalization

No	Instrument	Variable	Definition	Measurement	Scale	References
1	ESG1	ESG Score	Overall measure of a company's sustainability efforts.	ESG Disclosure/ESG Index	Ratio	GRI Standards
	ESG2	E Score	Measure of a company's environmental impact and disclosure.	E Disclosure/E Index	Ratio	GRI Standards

No	Instrument	Variable	Definition	Measurement	Scale	References
	ESG3	S Score	Measure of a company's social responsibility and disclosure.	S Disclosure/S Index	Ratio	GRI Standards
	ESG4	G Score	Measure of a company's governance practices and transparency.	G Disclosure/G Index	Ratio	GRI Standards
2	AQ1	KAP Size	Indicates if the audit was done by a top global accounting firm.	1 (Big Four KAP) and 0 (Non-Big Four KAP)	Nominal	(Siregar et al., 2012)
	AQ2	Firm Rotation	Shows if the audit firm has changed over time.	0 (No Rotation) and 1 (Firm Rotation)	Nominal	(Siregar et al., 2012)
	AQ3	Audit Tenur	The number of years the audit partner has worked with the company.	Number of years the audit partner has served as auditor	Ratio	(Siregar et al., 2012)
	AQ4	Partner Auditor Rotation	Indicates if the audit partner has been changed.	0 (No Rotation) and 1 (Partner Rotation)	Nominal	(Siregar et al., 2012)
3	PC1	Political Connections – Director	Shows if the company's director has political ties.	1 (Has Political Ties) and 0 (No Political Ties)	Nominal	(Hajriati et al., 2024)
	PC2	Political Connections-Commissioner	Shows if the company's commissioner has political ties.	1 (Has Political Ties) and 0 (No Political Ties)	Nominal	(Hajriati et al., 2024)
	PC3	Political Connections – Audit Committee	Shows if the audit committee has political ties.	1 (Has Political Ties) and 0 (No Political Ties)	Nominal	(Hajriati et al., 2024)
4	LV1	Debt-to-Equity Ratio	Measures how much debt a company has compared to its equity.	Total Liabilities/Total Equity	Ratio	(Brigham, 1978)
	LV2	Debt to Asset Ratio	Shows how much of a company's assets are financed by debt.	Total Liabilities/Total Assets	Ratio	(Brigham, 1978)
	LV3	Interest Coverage Ratio	Measures if a company can pay its interest expenses from earnings.	EBIT/Interest Expense	Ratio	(Brigham, 1978)
5	PR1	Net Profit Margin	Shows the percentage of revenue that is profit after all expenses.	Net Profit/Total Revenue	Ratio	(Brigham, 1978)
	PR2	Gross Profit Margin	Shows how much profit is left after the cost of goods sold.	(Revenue - COGS)/Revenue	Ratio	(Brigham, 1978)
	PR3	Return On Assets (ROA)	Measures how well a company uses its assets to generate profit.	Net Profit/Total Assets	Ratio	(Brigham, 1978)
	PR4	Return On Equity (ROE)	Measures how efficiently a company uses shareholders' equity to make a profit.	Net Profit/Shareholder Equity	Ratio	(Brigham, 1978)
	PR5	Return On Sales	Shows how profitable the company's sales are.	EBIT/Revenue	Ratio	(Brigham, 1978)
	PR6	Earnings Per Share (EPS)	Shows how much profit each share of the company earns.	Net Profit After Tax/Number of Shares Outstanding	Ratio	(Brigham, 1978)
6	FV1	Price-to-Earnings Ratio (P/E)	Measuring how much investors are willing to pay for each dollar of earnings.	Share Price/Earnings Per Share	Ratio	(Brigham, 1978)

No	Instrument	Variable	Definition	Measurement	Scale	References
	FV2	Tobin's Q	Compares a company's market value with the replacement cost of its assets.	((Share Price x Total Outstanding Shares) + Total Debt) / Total Assets	Ratio	(Tobin, 1969)
	FV3	Price-to-Book Value (PBV)	Showing how the market values a company relative to its book value.	Stock Price / Book Value per Share	Ratio	(Brigham, 1978)

Source: 2025 data processing

Results and Discussion

Descriptive Statistical Analysis

Descriptive statistical analysis is important to understand the basic characteristics of the dataset. Table 3 reports both dummy and continuous variables. The dummy variables (KAP Size and Political Connections) take values of 0 or 1. KAP Size has a mean of 0.74, indicating that most firms are audited by large (Big Four/top-tier) audit firms. Political connections are also relatively common, with averages of 0.51 for commissioners and 0.42 for audit committees, showing a fairly balanced distribution between politically connected and non-connected firms.

For continuous variables, the statistics highlight the distribution and spread of the data. The ESG Score has a mean of 0.53 with a standard deviation of 0.21, suggesting a moderate level of sustainability performance and noticeable variation across firms. Leverage is relatively high, as shown by the Debt-to-Equity Ratio mean of 2.36; its large standard deviation (2.07) indicates substantial differences in debt reliance among companies. Profitability is positive on average (ROA mean 0.07), while market-based measures such as Tobin's Q (mean 1.71) and PBV (mean 4.06) show wide dispersion, implying the presence of valuation outliers.

Table 3. Descriptive Statistical Analysis

Name	Type	Mean	Min	Max	Standard deviation
ESG Score	MET	0,53	0,15	1	0,21
E Score	MET	0,46	0,06	1	0,24
S Score	MET	0,51	0,08	1	0,23
G Score	MET	0,77	0,09	1	0,31
KAP Size	0|1	0,74	0	1	0,44
Political Connections-Commissioner	0|1	0,51	0	1	0,50
Political Connections – Audit Committee	0|1	0,42	0	1	0,49
Debt-to-Equity Ratio	MET	2,36	0,09	6,63	2,07
Debt to Asset Ratio	MET	0,56	0,08	0,87	0,24
Return On Assets (ROA)	MET	0,07	-0,01	0,3	0,06
Return On Equity (ROE)	MET	0,20	-0,05	1,52	0,29
Tobin's Q	MET	1,71	0,25	10,57	1,79
Price-to-Book Value (PBV)	MET	4,06	0,19	44,86	8,57

Source: 2025 data processing

Overall, these descriptive results provide a clear picture of central tendencies and variability, helping identify heterogeneity and potential outliers before further empirical testing.

Outer Model

To ensure the tool is legitimate and trustworthy, the outer model evaluates the relationship for latent constructs and their observed indicators. Convergent validity, also discriminant validity, and construct reliability are the three primary tests.

Convergent Validity and Construct Reliability

There are two methods to assess convergent validity, the loading factor and the average variance extracted (AVE). An indicator is deemed legitimate if its loading factor value is more than 0.70, which quantifies the correlation between an indicator and a laten variable. Indicators that do not satisfy these requirements ought to be eliminated. Meanwhile, AVE is considered valid if more than 0.5 for reliability, Cronbach's Alpha assessed the consistency of the variable measurements, with a value more than 0.7 indicating the construct was measured well and consistently. A composite reliability (CR) score of greater than 0.7 is regarded as meeting the research standards in SmartPLS. CR assesses the internal consistency of the indicators that make up latent variables (Hair et al., 2014).

In the first stage, the output of the loading factor value for the audit quality variable has three statements with values of AQ is -0.174, AQ3 is -0.194 and AQ4 is 0.432 and less than loading factor value of 0.70. Furthermore, the value of the political connection variable also has one statement with a value of PC1 is -0.427 and one statement of the leverage variable with a value of LV3 is 0.225, then there are four variables of profitability with a value of PR1is -0.290, PR2 is-0.227, PR5 is -0.451, PR6 is-0.224 and last but not least, the company's value variable has one statement with a value of PV1 is 0.572 and a loading factor value of 0.70. It is necessary to remove and retest statements with a loading factor value of 0.7.

Table 4. Result of Convergent Validity and Construct Reliability

Construct	Indicator	Loading Factor	Average Variance Extracted	Cronbach's Alpha	Composite Reliability
ESG	ESG1	0.989			
	ESG2	0.845	0.742	0.879	0.887
	ESG3	0.866			
	ESG4	0.726			
Audit Quality	AQ1	1.000			
Political Connections	PC2	0.890	0.871	0.867	1.219
	PC3	0.975			
Leverage	LV1	0.971	0.942	0.939	0.939
	LV2	0.971			
Profitability	PR3	0.952	0.919	0.912	0.929
	PR4	0.965			
Firm Value	FV2	0.991	0.982	0.982	0.983
	FV3	0.992			

Source: 2025 data processing

Table 4 is the result of a retest for the loading factor. The data can be regarded as legitimate as the test results indicated that the loading factor more than 0.7 and the Average Variance Extracted (AVE) more than 0.5. The validity of the model construct is supported by the indicator's ability to quantify correlation with latent variables. Furthermore, all variables show strong reliability, as indicated by Cronbach's Alpha and Composite Reliability both more than 0.7.

Discriminant Validity

Each construct or variable in the model is guaranteed to reflect unique concepts and not overlap with one another thanks to discriminant validity. Three techniques cross loading, Fornell-Larcker, additionally discriminant validity can be tested using latent variable correlation with. If an indicator's correlation with the latent variable (cross loading) is greater than its correlation with other variables, it is deemed legitimate (Hair et al., 2014). The cross loading in Table 5 displays the outcomes of data processing with SmartPLS version 4.

Table 5. Results of Cross Loading Discriminant Validity Test

Instruments	ESG	Audit Quality	Political Connections	Leverage	Profitability	Firm Value	Result
ESG1	0.989	0.253	0.220	0.367	0.124	0.181	Valid
ESG2	0.845	0.269	0.130	0.302	0.103	0.109	Valid
ESG3	0.866	0.160	0.165	0.274	0.146	0.220	Valid
ESG4	0.726	0.191	0.218	0.353	0.089	0.190	Valid
QA1	0.254	1.000	-0.098	0.396	0.154	0.170	Valid
PC2	0.177	-0.141	0.890	0.193	0.150	0.031	Valid
PC3	0.220	-0.069	0.975	0.276	0.298	0.251	Valid
LV1	0.380	0.364	0.305	0.971	0.080	0.222	Valid
LV2	0.359	0.406	0.205	0.971	0.104	0.278	Valid
PR3	0.032	0.071	0.238	-0.158	0.952	0.821	Valid
PR4	0.212	0.212	0.265	0.303	0.965	0.937	Valid
FV2	0.201	0.170	0.184	0.215	0.902	0.991	Valid
FV3	0.208	0.167	0.191	0.294	0.925	0.992	Valid

Source: 2025 data processing

Cross loading values for ESG variables, audit quality, political connections, leverage, profitability, and firm value showed that the correlation of the indicators with their variables was higher compared to other variables. All valid indicators are indicated by the consistent findings of the discriminant validity and convergent validity tests. This demonstrates that the model is suitable and capable of successfully differentiating between constructs, hence establishing the validity of this study measuring tool.

Inner Model

PLS-SEM's inner model illustrates the connections for latent variables and is assessed for significance and strength. R Square, significance of the relationship (hypothesis testing), and effect magnitude were the three primary components of the evaluation.

R Square (R^2)

The degree to which latent independent factors account for the variability of latent dependent variables is measured by R-Square in PLS-SEM. The model's predictive capacity is indicated by the R^2 value, which ranges from 0 to 1. Higher values indicate that the model is better able to explain variance. These are the analysis's R-Square values.

Table 6. Value R Square (R^2)

Var. Dependency and Mediation	R-square	R-square adjusted
Firm Value	0.896	0.888
Leverage	0.297	0.266
Profitability	0.103	0.063

Source: 2025 data processing

Table 6 showed that the R-Square firm value was 0.896, meaning that 89.6% of the variation was explained by independent variables, meaning that the relationship was very strong. Leverage 0.297, only 29.7% explained model means medium relationship, while Profitability 0.103, only 10.3% explained model means weak relationship, mostly influenced by external factors.

Direct and Indirect Effect

The use of one-tailed test in this study is based on the nature of the hypothesis which is directional (positive). In spite of (Hair et al., 2017) in Primer on PLS-SEM generally only provides guidelines for two-tailed tests (t more than 1,96 for α is 5 percent), the theoretical literature of inferential statistics supports the use of cutoffs t more than 1,64 for one-tailed. Moreover, (Kock, 2015) recommends the use of one-tailed P-values in the context of PLS-SEM when the direction of the effect has been established a priori.

Table 7. The Result of Path Coefficient Bootstrapping Direct and Indirect Effect

Hipotesis	Path Coefficient	Original sample (O)	T statistics (|O/STDEV|)	P values	Result
H1	ESG → Leverage	0.236	2.466	0.007	Confirmed
H2	ESG → Profitability	0.032	0.276	0.391	Rejected
H3	ESG → Firm Value	0.047	0.857	0.196	Rejected
H4	Audit Quality → Leverage	0.819	3.530	0.000	Confirmed
H5	Audit Quality → Profitability	0.391	2.624	0.004	Confirmed
H6	Audit Quality → Firm Value	-0.200	1.531	0.063	Rejected
H7	Political Connections → Leverage	0.498	2.300	0.011	Confirmed
H8	Political Connections → Profitability	0.552	3.006	0.001	Confirmed
H9	Political Connections → Firm Value	-0.275	1.971	0.024	Confirmed
H10	Leverage → Firm Value	0.221	3.637	0.000	Confirmed
H11	Profitability → Firm Value	0.944	11.039	0.000	Confirmed
H12	ESG → Leverage → Firm Value	0.052	1.913	0.028	Confirmed
H13	ESG → Profitability → Firm Value	0.030	0.283	0.388	Rejected
H14	Audit Quality → Leverage → Firm Value	0.181	2.707	0.003	Confirmed
H15	Audit Quality → Profitability → Firm Value	0.369	2.749	0.003	Confirmed
H16	Political Connections →Leverage → Firm Value	0.110	2.042	0.021	Confirmed
H17	Political Connections → Profitability → Firm Value	0.521	2.863	0.002	Confirmed

Source: 2025 data processing

Table 7 shows the analysis's findings for Path Coefficient Bootstrapping Direct and Indirect Effect, which include a coefficient value of 0.236, T-statistic of 2.466, and P-value of 0.007, demonstrate that ESG practices significantly affect leverage. This suggests that firms with stronger ESG practices tend to adopt more debt-intensive financing structures. However, ESG had no significant effect on profitability (β is 0.032; T is 0.276; P is 0.391) and firm value (β is 0.047; T is 0.857; P is 0.196), so the influence on these two variables is statistically weak.

Audit quality showed a significant positive influence on leverage (β is 0.819; T is 3,530; P is 0.000) and profitability (β is 0.391; T is 2,624; P is 0.004), indicates that quality audits increase investor confidence, facilitate access to financing, and encourage operational efficiency. However, the effect on the firm value wasn't significant (β is -0.200; T is 1,531; P is 0.063).

Meanwhile, political connections have a significant effect on leverage (β is 0.498; T is 2,300; P is 0.011) and profitability (β is 0.552; T is 3.006; P is 0.001), while exerting a statistically significant negative effect on firm value (β is -0.275; T is 1,971; P is 0.024). This suggests that political connections facilitate access to financing and support profitability, but over-reliance can lower a company's market value.

In addition, leverage has a significant positive effect on firm value (β is 0.221; T is 3,637; P is 0.000), while profitability also has a greater significant positive influence on firm value (β is 0.944; T is 11,039; P is 0.000). As such, leverage and profitability are key factors that determine a company's value, although ESG, audit quality, and political connections affect these variables differently.

For indirect effects, it demonstrates ESG has a substantial indirect effect on firm value through leverage (β is 0.052; T is 1,913; P is 0.028), but the effect through profitability wasn't significant (β is 0.030; T is 0.283; P is 0.388). Audit quality significantly affect the firm value both through leverage (β is 0.181; T is 2,707; P is 0.003) and profitability (β is 0.369; T is 2,749; P is 0.003) and political connections further exert a statistically significant positive effect through leverage (β is 0.110; T is 2,042; P is 0.021) and profitability (β is 0.521; T is 2,042; P is 0.021), indicating that leverage and profitability are the main pathways effect the firm value.

Effect Size (f^2)

The precise impact of independent variables on dependent variables is evaluated using the effect size (f^2) metric. Comparisons of R^2 values following the removal of an independent variable from the model were used to make measurements. According to Hair et al. (2014), the f^2 value can be classified as tiny (less than 0.02), medium (0.02 until 0.15), or large (more than 0.35). Consequently, f^2 gives academics a better understanding of the connections between latent variables by assisting them in determining which independent factors have the greatest influence.

Table 8. Effect Size (f^2) Test Results

Variable	ESG	Audit Quality	Political Connections	Leverage	Profitability	Firm Value
ESG				0.069	0.001	0.017
Audit Quality				0.169	0.030	0.056
Political Connections				0.080	0.077	0.141
Leverage						0.326
Profitability						7.618
Firm Value						

Source: 2025 data processing

The effect size (f^2) results from Table 8 showed that ESG had a moderate effect on leverage (f^2 is 0.069) but small on profitability (f^2 is 0.001) and firm value (f^2 is 0.017). Audit quality has a large effect on leverage (f^2 is 0.169), small on profitability (f^2 is 0.030), and medium on company value (f^2 is 0.056). Political connections have a moderate effect on leverage (f^2 is 0.080) and profitability (f^2 is 0.077), as well as a large effect on firm value (f^2 is 0.141). Meanwhile, leverage (f^2 is 0.326) and especially profitability (f^2 is 7.618) has a large to very large influence on the firm value, indicating that both are the main factors determining the firm value.

Discussion

The results on direct effects show that ESG does not significantly influence firm value or profitability, and profitability also fails to mediate the ESG–firm value relationship. One possible explanation is that ESG programs typically require substantial upfront investment, while their returns tend to materialize only over the long term. In addition, the market may not fully price in ESG information yet, and differences in how firms implement ESG together with the limited variation among companies classified as ESG Leaders can dilute any immediate financial impact. These findings are consistent with Wahyono et al. (2024), who likewise report no direct link between ESG ratings and firm value. More broadly, integrating ESG into financial decision-making remains difficult because

widely accepted methods, benchmarks, and standards are still developing (Kuzmina et al., 2023). In line with this view, Firmansyah et al. (2023) find that ESG practices and disclosure requirements can raise operating costs, which may, at least in the short run, weaken financial performance.

From a legitimacy and signaling standpoint, ESG disclosure tends to function primarily as a reputational signal rather than an immediate driver of financial outcomes. Consequently, when firms are already classified as ESG Leaders and exhibit relatively low score dispersion, the marginal contribution of ESG to profitability and firm value is likely to be limited. Prior evidence points in the same direction. For instance, Li et al. (2024) report that ESG disclosure is associated with lower profitability among Chinese firms, especially those with weaker ESG performance. Similarly, Rahmawati (2023) finds that ESG risk ratings negatively relate to financial performance in Indonesia's telecommunications sector, while Zahid et al. (2022) show that stronger ESG engagement can reduce ROA-based performance. The present results also align with broader evidence from studies published between 2010 and 2022, which report an adverse association between firm value and ESG performance (Truong, 2025).

Research in the banking industry further suggests that ESG initiatives may suppress bank profitability and that greater dispersion in ESG ratings can heighten firm risk (Bao et al., 2024). In this context, Al-Shaer et al. (2025) define firm risk as the operational vulnerability arising from internal and external exposures that can affect profitability. One reason is that firms often commit substantial financial and non-financial resources to improve ESG performance (Kumar & Joseph, 2025). Zhou & Bu (2025) also emphasize that ESG investments typically require time to be absorbed by the market and translated into operational results. Although more efficient and profitable firms may be better positioned to mitigate these risks, the costs and uncertainties attached to ESG improvement mean that higher ESG scores can, in some cases, increase short-term financial risk (Ridwan & Alghifari, 2025).

ESG shows a strong direct effect on leverage, and leverage in turn can mediate the relationship between ESG and firm value. A plausible explanation is that firms with robust ESG profiles tend to gain easier access to external financing because creditors perceive them as less risky, which aligns with resource dependence theory. In this way, leverage becomes a financial pathway through which ESG strengths can be converted into value creation. Empirical evidence supports this mechanism: Malik & Kashiramka (2025) find that companies with higher ESG scores generally carry greater book and market leverage. Likewise, Birindelli et al. (2025) report a positive association between ESG ratings and leverage, with the link becoming stronger as ESG performance improves, particularly in industries where ESG coverage is still limited. From this perspective, stronger ESG performance tends to lower borrowing costs by mitigating financial risk, enhancing transparency, and reducing agency conflicts in debt contracts (Yang et al., 2024).

Audit quality has a direct influence on both profitability and leverage. Even though its direct effect on firm value may be small, audit quality can still shape firm value indirectly through these two financial channels. This is because high-quality audits work primarily as a governance mechanism: they reduce information asymmetry and agency conflicts, which improves firms' financial conditions and ultimately strengthens their value over time. Therefore, to build a healthier capital structure, enhance operating efficiency, and raise firm value, companies need to maintain strong audit quality. Recent studies emphasize that audits are increasingly central to corporate valuation since they promote financial integrity, transparency, and a safer environment for investors, which can lift market value (Santos-Jaén et al., 2025). In line with this, Wang and Liang (2025) document a significant positive link between better audit quality and value creation, with risk management acting as a key mediator. Vaihekoski and Yahya (2025) further show that audit quality reinforces the credibility of financial reports and investor confidence by moderating the ESG–firm value relationship. These results also align with Hana et al. (2024), who find that audit quality supports higher operational efficiency and effectiveness and contributes positively to firm value, even when its impact on profitability is not statistically strong.

Political connections exert a direct influence on leverage and profitability, yet they are associated with a decline in firm value. This pattern suggests that political ties can ease access to funding and support short-term financial gains, making leverage and profitability important channels through which these benefits arise. However, political connections also have a dual character: while they provide resources and advantages in the near term, they may simultaneously raise long-term risks, uncertainty, and agency problems that investors tend to view unfavorably. As a result, excessive reliance on political ties can ultimately erode firm value, increase uncertainty, and intensify potential agency conflicts. Prior findings are consistent with this view. Bussolo et al. (2022) show that politically connected firms often display lower capital productivity, weaker profitability, and higher leverage. In contrast, Tarmizi and Brahmana (2022) note that firms with strong political backing may enjoy greater operational influence and stronger market sustainability. Likewise, several studies argue that political ties can enhance performance (Najaf & Najaf, 2021; Latif et al., 2024), reinforcing the idea that political involvement can help firms financially even if the market discounts the longer-term risks.

Conclusion

This study shows that ESG practices help firms maintain healthier leverage structures and strengthen corporate reputation, even though their effects on profitability and firm value are mainly indirect. Audit quality contributes

by boosting investor trust and improving operational efficiency, which supports financial stability. Political connections, meanwhile, can open access to capital and strategic opportunities, but an excessive dependence on them may be viewed negatively by the market and ultimately weaken firm value. Taken together, the findings indicate that leverage and profitability are the key pathways through which ESG, audit quality, and political ties shape firm value. The study also confirms that PLS-SEM is well suited for analyzing complex networks of direct and indirect relationships among latent constructs.

Several implications follow from these results. Managers should approach ESG initiatives and audit-quality improvements as long-term strategic investments rather than expecting immediate financial payoffs. Investors, on the other hand, need to recognize that political connections may bring short-term advantages while also carrying longer-term risks. Regulators could use these insights to refine ESG disclosure requirements and reinforce audit governance frameworks, thereby improving disclosure clarity and market trust.

Despite its contributions, the study has limitations. The sample is relatively small and restricted to ESG Leader firms, and the observation window is short, covering only 2021–2024. Future research should extend the time horizon, include firms beyond the ESG Leader category, and incorporate additional mediating or moderating factors such as industry characteristics, ownership structure, or regulatory environment to deepen understanding of how these variables interact in shaping firm value.

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