InCAF PROCEEDING OF INTERNATIONAL CONFERENCE ON ACCOUNTING AND FINANCE

Volume 4, 2026, PP: 114-122

The mediating role of financial reporting quality in the relationship between ESG performance and firm value: evidence from SRI-KEHATI indexed firms

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Abstract

This study examines the relationship between Environmental, Social, and Governance (ESG) performance and firm value. It focuses on the mediating role of financial reporting quality among firms listed on Indonesia's SRI-KEHATI Index. Using data from 117 firm-year observations between 2018 and 2023, the study employs multiple regression and mediation analyses with Hayes' PROCESS Macro to evaluate direct and indirect effects. The results show that ESG performance significantly positively affects on firm value, indicating that companies that integrate sustainability practices into their strategies are valued more favorably by the market. However, the mediating effect of financial reporting quality is not statistically significant. This suggests that ESG primarily influences firm value through direct mechanisms, such as enhanced corporate reputation, stakeholder trust, and strategic positioning, rather than through improvements in financial reporting quality. These findings underscore the strategic importance of ESG integration as a driver of long-term value creation and investor confidence. Managers should view ESG as a strategic investment, emphasizing transparency, sustainability reporting, and stakeholder engagement. Future research should incorporate broader samples, objective ESG metrics, and emerging sustainability reporting frameworks to enhance generalizability and comparability.

Keywords: ESG, financial reporting quality, firm value, SRI-KEHATI

INTRODUCTION

The concept of sustainability has evolved into a fundamental component of modern business practices, compelling firms to incorporate Environmental, Social, and Governance (ESG) principles into their strategic frameworks. The ESG paradigm is increasingly regarded not solely as an ethical responsibility but as a strategic instrument that fosters long-term value creation, strengthens stakeholder trust, and enhances corporate reputation in a competitive global environment.

In Indonesia, the institutionalization of sustainability principles is exemplified by the SRI-KEHATI Index, which serves as a benchmark for publicly listed companies that demonstrate a strong commitment to sustainability and sound corporate governance practices. The firms included in this index are distinguished by their heightened transparency, accountability, and financial discipline, which collectively reflect elevated levels of integrity and credibility in their financial reporting processes.

The quality of financial reporting provides a tangible indication of these governance attributes. This phenomenon is frequently evidenced by the issuance of unqualified audit opinions, which signify the absence of material misstatements and compliance with prevailing accounting standards. Companies that are consistently listed in the SRI-KEHATI Index frequently obtain unqualified audit opinions, which underscores their adherence to rigorous reporting standards and responsible governance practices. This alignment indicates that a strong commitment to sustainability is intrinsically linked to transparent, credible, and independently verifiable financial reporting (Qadeer, 2025).

Beyond serving as an expression of corporate social responsibility, Environmental, Social, and Governance (ESG) performance functions as a strategic market signal that shapes investor perceptions and firm valuation through its impact on corporate reputation, risk mitigation, and access to capital (Rahat & Nguyen, 2024). Empirical evidence indicates that firms with strong ESG performance generally attain higher market valuations and benefit from enhanced investor trust and confidence (Aydoğmuş et al., 2022; Rahat & Nguyen, 2024).

It is widely recognized that good ESG performance has substantial implications for financial reporting quality. This is due to the fact that firms with stronger governance mechanisms are more likely to uphold transparency, accountability, and ethical integrity throughout the reporting process. Empirical evidence indicates a positive association between higher ESG performance and earnings quality, as well as a negative association with real earnings management practices (Vatis et al., 2025). In accordance with these findings, recent studies have demonstrated that reliable ESG disclosures enhance the quality of financial reporting and fortify investor confidence in the reliability of corporate financial information (Alharasis et al., 2025). Such disclosures, when verified independently and transparently, contribute to more accurate reporting, which minimizes informational distortion and reinforces trust in the integrity of financial statements (Chen & Xie, 2022; Malik & Kashiramka, 2025). Furthermore, empirical evidence suggests that firms with comprehensive ESG disclosures tend to exhibit superior earnings quality. This phenomenon can be attributed to the effective governance mechanisms that mitigate opportunistic managerial behavior and constrain earnings management practices (Vivel-Búa et al., 2024). Consequently, reliable ESG disclosure functions not only as an instrument of social legitimacy but also as a strategic mechanism that enhances the quality of financial reporting and bolsters investor trust in capital markets.

Despite the prevailing association of ESG disclosure with enhanced firm value and improved financial reporting quality, the extant empirical evidence remains inconclusive. Several studies have documented a significant positive association between ESG performance and financial outcomes. However, other studies have reported mixed or even negative results, depending on contextual factors such as industry characteristics and institutional environments (Aydoğmuş et al., 2022; Rahat & Nguyen, 2024). This discrepancy suggests that the relationship between ESG performance and firm value may not be purely direct; rather, it may be mediated by intervening variables. In this regard, the quality of financial reporting is frequently identified as a key transmission mechanism through which ESG influences firm performance. The rationale underlying this assertion is that the provision of credible and transparent financial reporting strengthens stakeholder trust, thereby facilitating the translation of ESG initiatives into tangible economic value (Qadeer, 2025; Vatis et al., 2025).

In light of the paucity of empirical evidence and the theoretical significance of this mediating pathway, the present study endeavors to provide a more profound understanding of the influence of ESG performance on firm value through the lens of financial reporting quality. Specifically, the study examines the direct effect of ESG performance on firm value and the indirect effect mediated by the financial reporting quality (FRQ). The study focuses on companies listed in the SRI-KEHATI Index of the Indonesia Stock Exchange. These are firms recognized for their strong commitment to sustainability and good corporate governance.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The present study is founded upon three principal theoretical foundations: Stakeholder Theory, Signaling Theory, and Agency Theory. According to the principles of Stakeholder Theory, the implementation of ESG principles reflects a firm's responsibility toward its various stakeholder groups. This, in turn, reinforces organizational legitimacy and contributes to long-term firm value creation (Freeman, 1984). Signaling Theory posits that credible ESG disclosures and transparent financial reports act as positive signals to investors, indicating the firm's commitment to transparency, effective risk management, and sustainable performance prospects (Goss & Roberts, 2011; Ross, 1977). The dissemination of these signals has been demonstrated to facilitate the mitigation of information asymmetries, thereby fostering investor confidence in the integrity of corporate entities. Conversely, Agency Theory underscores the significance of robust ESG practices and high-quality financial reporting in mitigating agency conflicts, enhancing managerial accountability, and aligning the interests of managers and shareholders (Jensen & Meckling, 1976). When considered collectively, these theoretical perspectives suggest that ESG performance influences firm value in both a direct and indirect manner. This influence occurs through financial reporting quality, which serves as a mediating mechanism linking sustainability efforts to financial outcomes.

ESG Performance and Firm Value

In the contemporary business environment, the concept of ESG performance has evolved from a mere ethical obligation to a strategic instrument for generating long-term economic value. ESG performance is indicative of a firm's commitment to sustainability, focusing not only on short-term profitability but also on generating enduring value for a wide range of stakeholders (Vatis et al., 2025). According to Stakeholder Theory, effective implementation of ESG principles by firms results in the acquisition of social legitimacy and increased support from the public, regulators, and investors, thereby ultimately enhancing market valuation (Duan et al., 2023; Wu & Id, 2023).

A high level of ESG performance also serves as a positive signal in line with Signaling Theory, conveying to investors the firm's governance quality, risk management capability, and long-term sustainability commitment (Angir, 2024). Empirical studies have corroborated these theoretical insights. For instance, Duan et al. (2023) found that ESG performance has a significant positive effect on firm value within China's manufacturing sector. In similar vein, Aktas (2024) reported that firms with higher ESG scores tend to achieve superior market valuations, driven by lower perceived risk and enhanced corporate reputation.

These findings suggest that the market values social responsibility and sound governance as indicators of effective risk management and sustainable performance (Wu et al., 2022; Freeman, 1984). Firms with higher ESG scores have been observed to demonstrate higher market valuations in comparison to those exhibiting substandard sustainability performance. This finding suggests that market actors prioritize social responsibility and sound corporate governance as critical indicators of effective risk management and sustainable performance.

However, it should be noted that not all studies have yielded consistent results. The impact of ESG factors on firm value appears to be contingent on governance quality, industry characteristics, and regulatory environments (Aktas, 2024). The findings of this study demonstrate that the relationship between ESG performance and firm value may not be direct; rather, it may be mediated by other organizational mechanisms.

The correlation between ESG performance and financial reporting quality can be elucidated through two theoretical frameworks. First, Stakeholder Theory posits that sustainability-oriented firms seek to maintain social legitimacy through transparent and credible financial reporting, demonstrating accountability to stakeholders. Secondly, Agency Theory posits that robust ESG practices can enhance governance effectiveness and mitigate potential conflicts of interest between managers and shareholders (Wu & Abeysekera, 2023).

Consequently, a robust ESG performance not only enhances reputation and public trust but also reflects a firm's commitment to integrity, transparency, and accountability in financial reporting. Based on these theoretical and empirical foundations, the following hypothesis is proposed:

H1: ESG performance positively influences firm value.

Financial Reporting Quality as a Mediating Variable

Financial Reporting Quality serves as a fundamental indicator of the reliability and credibility of the information disclosed by firms to the market. According to Agency Theory, the provision of high-quality financial reports reduce information asymmetry between management and capital providers, thereby minimizing opportunistic behaviors, such as earnings management (Muttakin, 2025; Jensen & Meckling, 1976).

Firms with strong ESG performance tend to uphold higher standards of transparency and accountability. This is because ESG disclosure reflects a commitment to ethical and responsible reporting practices (Vatis et al., 2025). Empirical evidence indicates that credible ESG disclosure is positively associated with reporting quality, as socially responsible firms have reputational incentives to maintain the integrity of their financial information (Alharasis et al., 2025). Consistently, companies that are consistently engaged in ESG practices exhibit higher levels of earnings persistence and higher accrual quality compared to companies with weaker ESG performance (Aktas, 2024). ESG performance functions not only as a means of achieving social legitimacy but also as a mechanism that enhances financial reporting quality. Verified and credible ESG practices have been shown to help reduce earnings manipulation, improve reporting transparency, and strengthen investor confidence in the integrity of corporate financial statements (Malik & Kashiramka, 2025).

The relationship between ESG performance and firm value is not always direct. Several studies have indicated that the aforementioned relationship may be mediated by internal governance and reporting mechanisms, including financial reporting quality (Qadeer, 2025; Vatis et al., 2025). Firms with higher ESG performance tend to adopt stricter governance systems and more disciplined reporting processes, which results in more reliable and credible financial information. This enhanced reliability has a positive effect on investor perceptions of the firm's prospects and enhances market valuation. In order to account for firm-specific characteristics, this study includes leverage and Return on Assets (ROA) as control variables. Capital structure and profitability are recognized as critical determinants of how effectively ESG performance translates into corporate value creation. High leverage may constrain investment flexibility and elevate financial risk, thereby weakening the ability to convert ESG advantages into firm value (Nair et al., 2019). Conversely, high profitability ROA reflects a firm's financial strength and capacity to support sustainability initiatives, which may reinforce the positive influence of ESG performance on firm value (Bui & Nguyen, 2023).

Leverage and profitability are widely recognized as critical control variables in empirical research investigating the relationship between environmental, social, and governance (ESG) performance and firm value. Leverage affects firm value through competing mechanisms, while moderate debt levels can enhance value via tax shields and financial leverage benefits, excessive leverage increases financial distress risk and limits a firm's capacity to fund ESG-related initiatives, thereby influencing stakeholder and investor risk assessments (Widoretno et al., 2025). In contrast, higher ROA reflects greater operational efficiency and financial resilience, enabling firms to allocate resources toward sustainability efforts and bolster credibility among market participants, which amplifies the positive association between ESG performance and firm value (Aydo & Ergun, 2022). By controlling for leverage and profitability, empirical models isolate the incremental contribution of ESG performance to firm value, mitigating potential confounding effects arising from differences in capital structure and operational efficiency. This methodological approach is theoretically grounded in agency theory (Jensen & Meckling, 1976), which highlights the implications of financing decisions for firm valuation, and in resource-based perspectives that position profitability as a key enabler of strategic ESG integration and long-term value creation.

From the perspective of Signaling Theory, credible financial reporting serves as an external signal that amplifies the effect of ESG performance on market perception. When strong ESG performance is complemented by transparent and distortion-free financial reporting, investor confidence in the firm's long-term sustainability and performance prospects is strengthened (Nair et al., 2019).

Based on these theoretical and empirical foundations, the following hypothesis is proposed:

H2: ESG performance positively influences firm value through the mediating role of financial reporting quality.

RESEARCH METHOD

This study employs a quantitative research design to examine the effect of Environmental, Social, and Governance (ESG) performance on firm value, with financial reporting quality serving as a mediating variable. To empirically test the proposed hypotheses, multiple regression analysis and mediation analysis were conducted using the PROCESS Macro developed by Hayes (2022). The selection of the PROCESS Macro was made on the basis of its capacity to estimate both direct and indirect effects within a single regression framework, thereby providing a comprehensive understanding of the causal relationships among the studied variables.

The research population comprises all companies listed in the SRI-KEHATI Index on the Indonesia Stock Exchange (IDX) during the period 2018–2023. The index in question was selected on the basis of its inclusion of firms that have demonstrated a consistent commitment to sustainability practices and good corporate governance. The research sample was selected using a purposive sampling technique based on the following criteria: (1) Companies that disseminate both a comprehensive annual report and a sustainability report; and (2) Companies that possess complete and accessible data required for the analysis. This study utilizes secondary data, including ESG scores and financial statement information obtained from official publications and databases. Initially, 150 observations were collected. Following the exclusion of five observations due to missing data and 28 observations identified as outliers; a total of 117 valid observations were retained for further analysis.

The variables in this study consist of dependent, independent, mediating, and control variables. The dependent variable is firm value, which is measured using the Tobin's Q ratio. Tobin's Q reflects the extent to which the market values a company relative to the value of its assets. The measurement formula follows:

$$\textit{Tobin's Q} = (\textit{Stock Price} \times \textit{Number of Outstanding Shares}) + \textit{Total Liabilities})/\textit{Total Assets}$$

The independent variable in this study is ESG performance. ESG performance is measured based on the total ESG score, which reflects a company's effectiveness in managing the three main dimensions of sustainability (environmental, social, and governance) by integrating them into a weighted average composite score.

The mediating variable in this study is financial reporting quality. Financial reporting quality is measured by the level of discretionary accruals (DA), which is estimated using the Modified Jones Model developed by Kothari et al., (2005). This model incorporates the return on assets (ROA) as a performance adjustment variable, and is formulated as follows:

$$DA = TA/A_{t-1} - [\alpha_1(1/A_{t-1}) + \alpha_2((\Delta REV - \Delta REC)/A_{t-1}) + \alpha_3(PPE/A_{t-1}) + \alpha_4 ROA_{t-1}]$$

The control variables in this study are leverage and return on assets (ROA). Leverage is employed as the primary control variable, denoting the degree to which a firm relies on external financing through debt. Leverage is measured by the ratio of total liabilities to total assets. This is in accordance with the agency theory proposed by Jensen and Meckling (1976), which posits that capital structure influences both managerial monitoring and risk exposure.

Concurrently, ROA serves as the secondary control variable, representing the firm's level of profitability. ROA is calculated as the ratio of net income to total assets, reflecting the firm's efficiency in utilizing its assets to generate earnings.

Hypotheses 1 were tested using the following equation:

$$FV = \alpha + \alpha_1 ESG + \alpha_2 LEV + \alpha_3 ROA + \varepsilon \ldots\ldots\ldots\ldots\ldots\ldots \quad (1)$$

Hypotheses 2 were tested using the following equation:

$$FV = \alpha + \alpha_1 ESG + \alpha_2 M + \alpha_2 LEV + \alpha_3 ROA + \varepsilon \ldots\ldots\ldots \quad (2)$$

Where: FV = Firm Value; ESG = Environmental, Social, and Governance Score; M = Financial Reporting Quality; LEV = Leverage; ROA = Return on Assets.

RESULT AND DISCUSSION

Tabel 1. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ESG	117	.1270	.7228	.374257	.1580814
M	117	-2.0840	3.2763	.723380	1.1424349
LEV	117	.0602	.8897	.538764	.2300836
ROA	117	-.0106	.1376	.053353	.0410987

Q	117	.2680	2.2400	1.176929	.5276136

Table 1 presents the descriptive statistics of all variables utilized in this study. The analysis grounded in a comprehensive set of 117 firm-year observations. The findings indicate that the ESG score exhibits a mean value of 0.3743, with a minimum of 0.1270 and a maximum of 0.7228, indicating variation in the level of sustainability performance among the sampled firms. The financial reporting quality variable (M), measured by discretionary accruals, has a mean of 0.7234 and a relatively high standard deviation of 1.1424, suggesting considerable variability in the quality of financial reporting across firms.

Leverage (LEV) has an average of 0.5388, with a range of 0.0602 to 0.8897. This indicates that the majority of the firms in the sample moderately rely on debt financing. The average ROA is 0.0534, with values ranging from –0.0106 to 0.1376, indicating that, on average, firms generate a 5.34% return on their total assets. Finally, the firm value (Q), measured using Tobin's Q, shows a mean of 1.1769, with a minimum of 0.2680 and a maximum of 2.2400. This finding indicates that, on average, the market values these firms slightly above their book value, suggesting relatively efficient market performance among the companies included in the sample.

Tabel 2. Hypotesis testing

	Coefficient	p-value	CI-Confidence Interval (95%)	Result
H1	0.7362	0.022		Significant
H2	0.7362	0.022	[-0.1303; 0.0699]	Not Mediated

Hypothesis 1 proposes that ESG performance positively and significantly affects firm value. The empirical results indicate a significance level of $p = 0.022$ and a regression coefficient of 0.7362, confirming that firms with higher ESG performance tend to attain greater valuation (Yu & Xiao, 2022). This suggests that investors and stakeholders respond favorably to firms that incorporate sustainability practices into their operations. Such practices have the potential to mitigate business risk, strengthen corporate reputation, and augment long-term profitability.

These findings align with stakeholder and legitimacy theories, which assert that responsible corporate behavior enhances a firm's legitimacy and competitive advantage in the market. The findings further substantiate the assertion that ESG initiatives are instrumental in fostering sustainable value creation by aligning corporate goals with stakeholder expectations. From a managerial perspective, ESG initiatives should be regarded as strategic investments rather than compliance obligations. Managers are encouraged to prioritize enhancing transparency, sustainability reporting, and stakeholder engagement to improve both corporate reputation and financial performance. By implementing these measures, firms can build stronger trust with investors and achieve long-term sustainable growth.

The mediation analysis indicates that the indirect effect of ESG performance on firm value through Financial Reporting Quality is not significant (*Effect* = –0.0196; *BootSE* = 0.0469; 95% CI [–0.1303, 0.0699]). Because the confidence interval includes zero, the mediating effect of Financial Reporting Quality is statistically insignificant (Sarstedt et al., 2021). Consequently, Hypothesis 2 is not supported. This finding suggests that Financial Reporting Quality does not serve as a meaningful mediator in the relationship between ESG performance and firm value. In essence, enhancements in ESG performance influence firm value primarily through a direct pathway. Theoretically, this outcome reflects a direct-only non-mediation model, indicating that other internal or contextual mechanisms, beyond Financial Reporting Quality, may provide a more comprehensive explanation of how ESG initiatives enhance firm valuation (Hair & Ringle, 2022). Earnings management indicators generally fail to serve as reliable proxies for the credibility and integrity of financial reporting in the context of environmental, social, and governance (ESG) sustainability. This limitation arises because earnings management practices are predominantly driven by short-term financial incentives rather than a commitment to long-term transparency and accountability (Jensen & Meckling, 1976). Consequently, while such practices may temporarily inflate reported earnings, they do not substantively enhance the overall trustworthiness or transparency of financial disclosures.

From a managerial perspective, the results imply that improving the quality of financial reporting alone is insufficient to strengthen the impact of ESG performance on firm value. Consequently, managers must prioritize direct ESG strategies, encompassing environmental efficiency, social responsibility, and governance transparency, as these strategies directly contribute to investor confidence and long-term value creation. At the same time, maintaining high-quality financial reporting remains imperative to ensure credibility and regulatory compliance, which support sustainable corporate growth.

CONCLUSION

This study examines the impact of Environmental, Social, and Governance (ESG) performance on firm value, with financial reporting quality serving as a potential mediating variable. A study of data from firms listed in the SRI-KEHATI index reveals a significant positive effect of ESG performance on firm value. This finding suggests that companies integrating sustainability practices into their operations are generally valued more favorably by the market. In contrast, the analysis demostrates that financial reporting quality does not significantly mediate this relationship, indicating that the effect of ESG on firm value occurs primarily through direct mechanisms related to strategic positioning, stakeholder perceptions, and corporate reputation, rather than through improvements in financial reporting quality.

From a managerial perspective, these findings underscore the importance of ESG as a core component of corporate strategy. It is imperative for firms to conceptualize ESG initiatives as strategic assets with the potential to enhance competitiveness, foster investor confidence, and support long-term growth. In practice, this entails maintaining high standards of transparency, stakeholder engagement, and sustainability reporting to strengthen both corporate image and financial performance. Integrating sustainability principles into the core of business operations enables managers to reinforce the company's market position while increasing its potential for long-term value creation.

Despite the valuable insights offered by the study, it is important to acknowledge the limitations of the research. First, the sample is limited to firms included in the SRI-KEHATI index, which may restrict the generalizability of the findings to other industries or markets with different ESG standards. Secondly, ESG performance was measured using scores derived from narrative sustainability reports, which may introduce subjective bias. Lastly, this study did not consider external factors such as regulations, corporate culture, and market conditions that may influence the relationship between ESG and financial reporting quality. It is recommended that future research employ more standardized ESG frameworks, including the adoption of new sustainability accounting standards such as IFRS S1 and S2, to enhance the objectivity and comparability of ESG disclosures. Furthermore, the integration of quantitative and qualitative methodologies could facilitate a more profound comprehension of the motivations and practices underpinning ESG reporting. Additionally, it would enable an examination of the impact of external factors within the framework of implementing these novel sustainability standards.

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