

Sustainability performance as a governance mechanism: The moderating role in accounting conservatism and tax avoidance in Indonesia

Naila Hanum*, Raden Roro Diana Atika Ghozali, Rissa Anandita, Gabrielle J. Salma Silalahi

Diponegoro University, Semarang, Indonesia

*Corresponding Email addresses: nailahanum27@gmail.com

Abstract

This study examines the role of Environmental, Social, and Governance (ESG) performance in moderating the relationship between accounting conservatism and tax avoidance among Indonesian listed firms. Using firm-level financial and ESG data obtained from Bloomberg, the analysis was conducted with Stata 17 employing multiple regression and standard diagnostic tests, including heteroskedasticity and multicollinearity assessments. The findings reveal that accounting conservatism does not have a significant direct effect on tax avoidance, indicating that conservative reporting alone does not sufficiently influence firms' tax strategies. However, ESG performance significantly moderates the association between conservatism and tax avoidance, thereby functioning as a quasi moderator. This suggests that the effectiveness of accounting conservatism in shaping ethical tax behavior becomes meaningful only when firms exhibit strong ESG practices. High ESG performance reinforces transparency, ethical conduct, and stakeholder accountability, which in turn conditions how conservatism influences tax-related decisions. The results contribute to the growing literature on sustainability-oriented governance by providing evidence from an emerging market context. The study highlights the importance of integrating ESG into corporate governance structures, as ESG practices not only enhance reporting credibility but also strengthen firms' commitment to responsible tax behavior. These findings offer practical implications for regulators, policymakers, and firms seeking to align financial reporting with ethical and sustainable governance standards.

Keywords: ESG performance; accounting conservatism; tax avoidance

INTRODUCTION

The implementation of Environmental, Social, and Governance (ESG) initiatives often sparks debates regarding their authenticity and potential underlying motives, such as conservative strategies or opportunistic tax avoidance. The relationship between accounting conservatism, tax avoidance, and Environmental, Social, and Governance (ESG) scores is a multifaceted area of study that has drawn attention due to its implications for corporate governance and ethical business practices. Accounting conservatism, characterized by prudent financial reporting, often results in early recognition of potential losses and delayed recognition of gains. This prudence can impact tax-planning strategies, including tax avoidance. While some may question whether ESG practices are genuine or merely a guise for conservative methods, research provides insight into how they can impact tax avoidance behavior and firm valuation. In emerging markets, there is a noticeable trend towards increased ESG disclosures, driven by the growing demand to align with sustainability goals, such as the United Nations Sustainable Development Goals (SDGs) (Kumar Soni, 2023).

The integration of ESG not only signifies a response to market pressures but can also serve as a strategic tool to enhance firm performance and manage tax obligations strategically. Studies have explored the relationship between corporate tax avoidance and ESG performance. For instance, firms exhibiting high tax avoidance tend to show higher ESG performance; however, this effect diminishes when financial constraints increase, suggesting a complex interplay (Mohamad Ariff et al., 2024). ESG

practices can mitigate the relationship between tax avoidance and firm value by enhancing firm valuation when ESG performance is high; however, this effect might be reduced when tax liabilities increase (Elamer et al., 2024). Furthermore, negative media coverage on ESG issues can deter tax avoidance, indicating that media acts as an external monitor compelling firms to align their publicly declared ESG policies better with their tax strategies to regain legitimacy (Menicacci & Simoni, 2024). In the G20 countries, ESG reporting mediates the relationship between board characteristics and tax avoidance, suggesting that robust governance mechanisms play a central role in regulating tax strategies (Khlifi et al., 2024). Overall, while concerns about the authenticity of ESG practices in emerging markets persist, evidence suggests their potential to influence firm behavior and value, especially in areas such as tax strategy and public perception. However, the genuine integration of ESG into business models may require a more holistic commitment to sustainable practices, beyond just responding to external pressures (Aldowaish et al., 2022).

Existing studies on accounting conservatism and tax avoidance have explored various dimensions and dynamics of these practices. For instance, research has shown that managerial risk incentives and accounting conservatism are positively related due to firms employing conservatism to manage increased risk from excessive managerial risk incentives (Hu & Jiang, 2018). Furthermore, a study identified that the political orientation of managers plays a role in tax avoidance, suggesting that conservative managers are less likely to engage in aggressive tax avoidance practices (Christensen et al., 2014). This adds complexity to our understanding of how personal characteristics influence corporate financial strategies. Regarding the role of ESG factors in corporate financial decisions, studies have generally demonstrated the positive impact of ESG practices on corporate financial performance. For instance, ESG factors have been shown to enhance both market and accounting indicators of corporate financial performance, suggesting that consideration of ESG factors may be integrated into corporate decision-making to improve financial outcomes (Mardini, 2022). However, the implementation costs of ESG practices during crisis periods, such as the COVID-19 pandemic, revealed a potential negative impact on financial performance, highlighting the challenges of balancing ESG integration under financial constraints (Nareswari et al., 2023).

Several areas require further exploration in terms of gaps in the current literature, particularly in the Indonesian context. For example, the implementation of accounting standards in Indonesia faces challenges such as inefficiencies due to reform inconsistencies, offering a research opportunity to better understand the reconciliation between standard ideals and practical applications (Jatmiko Wahyu Prabowo et al., 2017). Additionally, while studies have addressed issues in accrual accounting in the Indonesian corporation and its complex history (Harun et al., 2012), there is a need for a deeper examination of how cultural and regulatory factors specific to Indonesia shape financial reporting practices. Overall, these gaps suggest that future research could benefit from a more localized focus on the implications of global financial practices and frameworks within Indonesia, considering its unique socio-economic and regulatory environment. Such insights could aid in forming more tailored strategies to foster sustainable financial growth and accountability in the Indonesian corporate sector.

The primary objective of this study is to analyze the impact of accounting conservatism on tax avoidance, as corporate financial reporting plays a crucial role in shaping tax strategies and regulatory compliance (Caskey & Laux, 2017). Accounting conservatism, characterized by cautious and prudent reporting, can influence the extent to which firms engage in tax avoidance practices (Wang et al., 2019). This study explores how environmental, social, and governance (ESG) scores moderate this relationship, as firms with higher ESG scores may exhibit different levels of transparency and ethical considerations in their financial practices (Shaikh, 2022). Understanding this moderating effect is crucial for highlighting how sustainable and ethical practices can potentially curtail aggressive tax planning (Madison & Schiehl, 2021). Additionally, this study aims to provide insights specific to the Indonesian business environment, which is characterized by unique regulatory and economic challenges that influence corporate accounting and tax strategies (Kalbuana et al., 2023). By focusing on Indonesia, this study intends to shed light on the regional nuances that affect the interplay between accounting conservatism, ESG scores, and tax avoidance in a developing economy context (Besdy et al., 2024). The integration of theoretical contributions in the accounting and economic literature offers

substantial insights that policymakers, regulators, and corporate entities can leverage to enhance sustainable business practices in Indonesia. This intersection of theory and practice underscores the necessity of a holistic approach that balances economic, social, and environmental dimensions, commonly referred to as a "Triple Bottom Line" strategy.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Agency Theory

Agency theory plays a significant role in understanding the dynamics of accounting conservatism and tax avoidance. The theory primarily focuses on resolving conflicts of interest between principals (shareholders) and agents (executives) within a corporation. In the context of accounting conservatism, agency theory suggests that conservative financial reporting can alleviate agency costs by providing more reliable financial signals that reduce information asymmetry between managers and stakeholders (Penalva & Wagenhofer, 2019; Zhong & Li, 2016). This enhanced transparency can help mitigate the potential for managers' opportunistic behavior, thus aligning the interests of managers and shareholders or creditors (Khurana & Wang, 2015). Regarding tax avoidance, agency theory offers insights into how managerial incentives might influence corporate tax strategies. Aligning managerial incentives with shareholder interests through mechanisms such as stock options can encourage behaviors that may prioritize tax efficiency, potentially involving risky tax strategies. For instance, the implications of CEO stock options for tax avoidance highlight a complex interplay in which CEOs weigh shareholder demands against personal financial incentives, sometimes amplifying tax avoidance to meet or exceed expectations set by peer performance (Zolotoy et al., 2020). Concisely, agency theory is relevant and insightful for developing hypotheses related to conservatism in accounting and tax avoidance. It provides a framework for understanding how differing interests and incentives among corporate stakeholders can influence financial reporting and tax strategies, potentially leading to varying levels of conservatism or aggressiveness in financial policy.

Accounting Conservatism

Accounting conservatism is a fundamental principle that instructs accountants to apply prudent methods when uncertainties arise, ensuring that potential losses are recognized promptly, while gains are acknowledged only when realized. This principle minimizes the risk of overstating assets or income by encouraging conservative estimates and objective reports. Historically, conservatism emerged to safeguard the interests of creditors and stakeholders, and its significance has grown during financial crises. Accounting standards set by organizations such as the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have incorporated conservatism to strengthen financial reporting practices. In financial reporting, conservatism is vital for maintaining investor confidence, managing risk, enhancing comparability across periods and organizations and ensuring regulatory compliance. By promoting conservative reporting, organizations can provide transparent and reliable financial information, support market integrity, and aid informed decision-making (Haring, Jr, 1979; Ismail et al., 2023).

Tax Avoidance

The conceptual framework of tax avoidance in corporate settings revolves around navigating the legal and ethical dimensions of tax planning. Legally, tax avoidance involves structuring business operations and financial activities to minimize tax liabilities within the bounds of the law, using various tax codes and regulations to the company's advantage (Wang et al., 2019). However, ethical considerations prompt companies to evaluate whether such practices align with societal expectations of corporate responsibility. This includes the potential reputational damage stemming from aggressive tax avoidance, as society generally views tax avoidance in moral terms rather than merely legal compliance (Gribnau & Jallai, 2017). Common tax avoidance strategies in corporations involve the use of 'loopholes' in tax legislation, transfer pricing mechanisms, and the strategic use of tax havens to redirect profits to lower-tax jurisdictions (Darcy, 2016; Payne & Raiborn, 2015). Additionally, corporations may engage in corporate social responsibility (CSR) activities to counterbalance the

negative perceptions associated with their tax strategies to maintain a positive public image and legitimacy (Xu et al., 2022). The balancing of legal tactics and ethical considerations highlights the complex nature of corporate tax avoidance strategies.

Environmental, Social, and Governance (ESG)

ESG (Environmental, Social, and Governance) have the potential to enhance corporate performance through governance structures, affecting financial outcomes and consumer perception. Each category assesses different aspects of corporate performance. ESG scores are metrics used to evaluate a company's performance and risk management in three key areas: environmental impact (such as resource use, emissions, and sustainability practices), social responsibility (including labor practices, community engagement, and human rights), and governance (covering leadership, transparency, ethics, and shareholder rights). These scores help investors and stakeholders assess how well a company manages non-financial factors that can affect its long-term value and societal impact. Thus, ESG scores and practices, although complex in measurement and indexing, are integral to shaping sustainable corporate governance, especially in emerging markets such as Indonesia. They serve as vital tools for assessing corporate responsibility, risk, and long-term strategic goals, making them pivotal in investment and corporate governance practices. Despite the importance of ESG measurement in guiding corporate strategies, there is a lack of convergence in ESG-scoring models. These models often diverge in terms of their distribution and risk assessment, making it essential for corporate stakeholders to critically assess the validity of the specific ESG scoring approaches they use in decision-making (Dorfleitner et al., 2015).

Hypothesis Development

Accounting conservatism is a fundamental principle of financial reporting that emphasizes prudence in recognizing income and expenses. It requires that potential losses and liabilities be recorded promptly when there is reasonable evidence, while gains and assets are recognized only when they are assured or realized. This approach aims to provide a cautious and reliable representation of a company's financial position, minimizing the risk of overstating its financial health. The importance of accounting conservatism lies in its role in enhancing the credibility and reliability of financial statements. By adopting a conservative stance, financial reports tend to understate rather than overstate profits and assets, which protects stakeholders, such as investors, creditors, and regulators, from overly optimistic information that could lead to misguided decisions. Conservatism also helps mitigate information asymmetry between management and external users, supporting better risk assessment and more prudent decision making. Accounting conservatism ensures that financial reporting reflects a cautious view of a company's performance and position, fostering trust and stability in capital markets. Accounting conservatism ensures prudent financial reporting, which may limit aggressive tax avoidance practices. By recognizing potential losses more promptly, conservative firms face less pressure to manipulate taxable income, fostering a more transparent tax reporting environment. This perspective aligns with the notion that conservatism safeguards against information asymmetry and mitigates agency costs (Mora & Walker, 2015; Zhong & Li, 2016).

(H1): Accounting conservatism is negatively associated with tax avoidance.

In Indonesia and other ASEAN countries, ESG practices are influenced by several factors, including a company's strategic orientation and life cycle stage. Prospector-oriented companies are more proactive in adopting ESG practices than defender-oriented companies. Additionally, greater risk-taking is associated with reduced ESG practices, whereas mature companies are more likely to improve their ESG initiatives (Setiarini et al., 2023). Indonesian companies are increasingly recognizing the need for transparency and accountability, which has driven the importance of ESG practices in their governance frameworks (Setiarini et al., 2023). Tax-avoidance practices are often scrutinized for their ethical implications, particularly as they relate to a company's ESG performance. ESG scores reflect a company's commitment to sustainable and responsible operation. Several studies have explored how ESG performance interacts with corporate tax strategies, providing insights into the moderating

effects of ESG scores on tax-related decisions. ESG performance as a potential moderating factor in the relationship between accounting conservatism and tax avoidance. Companies with higher ESG scores often face greater public and investor scrutiny, which may reduce their engagement in aggressive tax avoidance. These insights are crucial for policymakers, corporate managers, and investors who aim to foster transparent and sustainable business practices.

(H2): ESG scores leverage the relationship between accounting conservatism and tax avoidance

These hypotheses provide a foundation for exploring how accounting practices, tax strategies, and ESG scores interact and influence business decisions, providing pathways for empirical investigation. Although theoretical support provides a basis for these hypotheses, empirical testing is essential to validate these relationships.

METHODS

The research design focuses on quantitative analysis of public companies listed on the Indonesia Stock Exchange (IDX) that indexed as The ESG Leader with purposive sampling, selects companies that meet specific criteria which are having ESG scores for 2022-2023 and reported profits to calculate Effective Tax Rate (ETR) ensuring that the sample was relevant to the research objectives. This study utilizes secondary data extracted from the Bloomberg database. ESG scores are instrumental in evaluating a company's sustainable practices across the environmental, social, and governance dimensions. This research model aims to examine the relationship between Accounting Conservatism (CA) and Tax Avoidance (ETR) with ESG practice (ESG Score) as the moderating variable. This approach considers companies with ESG scores from 2022 to 2023, enabling the exploration of how conservatism influence tax practice regarding the sustainable practices through ESG mechanism. The ETR measures a company's tax liability in relation to its earnings, providing insights into tax efficiency. The use of these metrics enables the evaluation of financial strategies and their alignment with or deviation from conservative financial management practices. Accounting conservatism, characterized by accounting policies and historical financial data to identify consistent and prudent financial reports. The empirical analysis, including the regression estimations, heteroscedasticity tests, and multicollinearity diagnostics, was executed using Stata 17

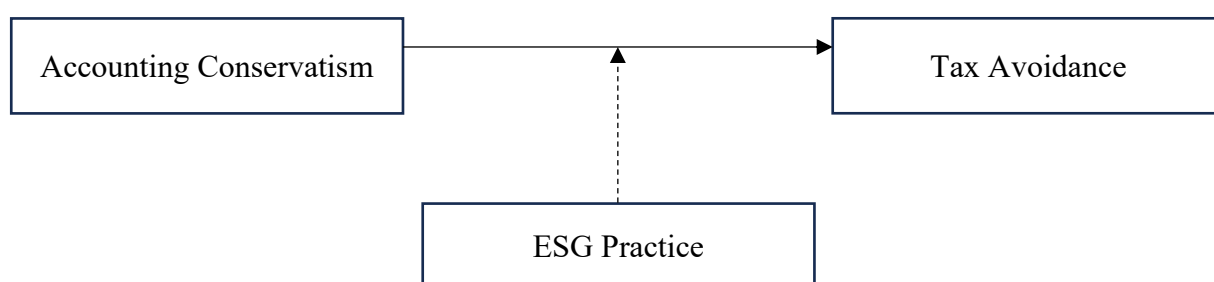


Figure 1. Conceptual Framework

RESULT AND DISCUSSION

Descriptive Statistics

Table results show that 60 firm-year observations were analysed. Accounting conservatism (CA) exhibits a wide dispersion (Mean = 576.76; SD = 6338.40), indicating substantial variation in firms' conservatism practices. The effective tax rate (ETR), used as an inverse indicator of tax avoidance, has a mean value of 21.50 with relatively moderate variability (SD = 8.50). ESG scores also show noticeable variation (Mean = 50.77; SD = 9.38), reflecting differences in firms' ESG engagement.

Table 1. Descriptive Statistics

Variable	Obs	Mean	Std. dev.	Min	Max
CA	60	576.7608	6338.406	-14860.07	39273.89
ETR	60	21.50267	8.503033	4.41	63.37
ESG	60	50.776	9.378945	33.82	67.91

Diagnostic Tests

The Breusch–Pagan test reports $\chi^2(1) = 1.97$ with a probability of 0.1606 (> 0.05), indicating that the null hypothesis of constant variance is not rejected. Thus, the model does not suffer from heteroskedasticity, and the residuals meet the homoskedasticity assumption.

Table 2. Heteroskedasticity Test

H0: Constant variance

chi2(1) = **1.97**
 Prob > chi2 = **0.1606**

Multicollinearity Test

Variance Inflation Factor (VIF) results show values of 1.26 for ESG, 1.24 for CAESG, and 1.05 for CA, with a mean VIF of 1.18. All values are well below the critical threshold of 10, indicating no multicollinearity issues. Each predictor contributes unique explanatory power to the model.

Table 3. Multicollinearity Test

Variable	VIF	1/VIF
ESG	1.26	0.794310
CAESG	1.24	0.809192
CA	1.05	0.954617
Mean VIF	1.18	

Hypothesis Testing

The coefficient of CA is positive but statistically insignificant ($\beta = 0.0000223$; $p = 0.177$). This indicates that accounting conservatism does not have a direct effect on tax avoidance therefor H1 is rejected. The interaction term CAESG is highly significant ($\beta = 0.0186668$; $p < 0.001$). This confirms that ESG practices change the magnitude and direction of the relationship between conservatism and tax avoidance therefor H2 is accepted. Notably, ESG independently has a significant negative coefficient ($\beta = -0.3754942$; $p < 0.001$), implying that higher ESG performance is associated with lower ETR (or lower tax avoidance). This reinforces ESG's governance and ethical oversight functions.

Table 4. Hypothesis Testing

ETR	Coefficient	Std. err.	t	P> t	[95% conf. interval]
CA	.0000223	.0000163	1.37	0.177	-.0000104 .000055
ESG	-.3754942	.0120971	-31.04	0.000	-.3997275 -.3512608
CAESG	.0186668	.0002251	82.92	0.000	.0182158 .0191177
_cons	20.11181	.5619023	35.79	0.000	18.98618 21.23743

Regression Analysis

Table results show that the model is statistically significant ($F(3,56) = 2338.38$, $p < 0.001$). The R-squared value of 0.9921 demonstrates that 99.21% of the variation in ETR is explained by CA, ESG, and the interaction term (CAESG). This signifies an exceptionally strong model fit.

Table 5. Regression Analysis

Source	SS	df	MS	Number of obs	=	60
Model	4232.00932	3	1410.66977	F(3, 56)	=	2338.38
Residual	33.7830554	56	.603268846	Prob > F	=	0.0000
				R-squared	=	0.9921
				Adj R-squared	=	0.9917
Total	4265.79237	59	72.3015656	Root MSE	=	.7767

The findings classify ESG as a quasi moderator because it significantly interacts with accounting conservatism (CA) to influence tax avoidance, even though CA itself does not have a significant direct effect on the dependent variable. In moderation theory, a quasi moderator is defined as a variable that produces a significant interaction effect but whose corresponding independent variable lacks a significant main effect. This means that ESG does not alter tax avoidance through conservatism in a straightforward or direct manner; instead, the presence of ESG practices conditions, strengthens, or reshapes the influence of conservatism only when both operate simultaneously. Consequently, accounting conservatism becomes relevant in explaining tax avoidance only within firms that exhibit higher ESG engagement.

Discussion

The findings reveal that accounting conservatism alone is insufficient to influence firms' tax avoidance behavior. However, when combined with strong ESG performance, conservatism becomes more relevant and influential. This suggests that firms with higher ESG commitments likely embed transparency, sustainability orientation, and stronger internal governance mechanisms, making the financial reporting discipline associated with conservatism more impactful in shaping tax strategies. Such results indicate that ESG operates as a governance-based constraint, ensuring that conservative accounting practices are aligned with ethical and sustainable tax conduct, also improving corporate accountability and reducing opportunistic behavior.

The significant moderating role of ESG aligns with existing international evidence suggesting that ESG practices shape firms' tax behavior by fostering greater transparency, reducing information asymmetry, and imposing implicit ethical constraints on managerial decisions. High ESG performance is commonly associated with enhanced stakeholder scrutiny, improved governance quality, and stronger expectations of ethical conduct, all of which may discourage aggressive tax strategies. As noted by Mohamad Ariff et al. (2024) and Zhang et al. (2024), ESG can create a "halo effect" that reinforces normative and reputational pressures, pushing firms toward more responsible tax practices. Supporting this argument, Yoon et al. (2021) found that firms with stronger ESG commitments are less likely to engage in tax avoidance, reflecting a corporate culture that values transparency and ethical behavior. This aligns well with the negative and significant coefficient of ESG in the present model, which indicates that higher ESG scores correspond with lower tax avoidance. Further evidence by Khlifi et al. (2024) shows that ESG reporting can mediate governance mechanisms and tax strategies, suggesting that ESG practices serve as an integrative control tool within corporate governance structures.

Nevertheless, the literature also highlights the possibility that ESG may be used opportunistically as a reputational shield. Mohamad Ariff et al. (2024) documented that in some contexts, firms with high tax avoidance levels appear to compensate through stronger ESG reporting—a phenomenon consistent with a "smokescreen" strategy. This underscores the duality of ESG: while it can reinforce ethical behavior, it may also provide cover for aggressive tax planning when used opportunistically. The interaction effect found in this study, however, suggests that in the Indonesian context, ESG functions more as a governance enhancer rather than a smokescreen, as it strengthens the influence of conservatism toward reducing tax avoidance. Moreover, Menicacci and Simoni (2024) demonstrate that firms facing more intense media scrutiny over ESG issues tend to reduce tax avoidance, highlighting the role of external monitoring. This finding supports the

interpretation that ESG practices heighten public visibility and stakeholder expectations, thereby intensifying the disciplining effect on managerial decisions related to tax strategies.

Collectively, these findings reinforce the notion that ESG practices play an important governance role in emerging markets. While sustainability reporting and ESG integration are still evolving in Indonesia, the presence of strong ESG performance appears to activate and enhance the behavioral implications of conservatism, demonstrating how ESG can convert a traditionally financial reporting mechanism into a broader tool for ethical governance.

CONCLUSION

This study provides empirical evidence that accounting conservatism alone does not significantly influence tax avoidance among Indonesian firms. However, the significant interaction between conservatism and ESG demonstrates that ESG acts as a quasi moderator, conditioning the effect of conservatism on tax avoidance. When firms adopt stronger ESG practices, conservatism becomes more effective in shaping ethical tax behavior. These findings highlight the transformative role of ESG, suggesting that sustainability-oriented governance structures strengthen the ethical consequences of financial reporting mechanisms. Overall, the results contribute to the literature by showing that ESG is not merely an external signaling tool but a substantive governance element capable of reshaping managerial incentives and aligning tax strategies with ethical expectations. For policymakers, the findings emphasize the importance of encouraging ESG integration and sustainability reporting to enhance corporate compliance and reduce aggressive tax practices. For firms, the results underscore the strategic value of embedding ESG into governance systems, as ESG can amplify the positive effects of accounting conservatism and reinforce ethical decision-making.

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