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Factors Driving the Quality of Financial Reporting in Non-Financial Public Companies in Indonesia

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General Background: Financial reporting quality (FRQ) is critical to stakeholders, as it supports making informed economic decisions based on reliable corporate financial statements. **Specific Background:** The cases of fraudulent reporting committed by PT Garuda Indonesia Tbk (2019) and PT Asuransi Jiwasraya (2021) underscore the urgency to ensure financial statements reflect a true and fair view. **Knowledge Gaps:** Existing literature lacks a comprehensive approach that integrates various models and non-financial determinants, such as Environmental, Social, and Governance (ESG) factors, in assessing FRQ. **Objectives:** This study aims to examine the effect of corporate governance mechanisms, financial leverage, audit quality, and ESG performance on FRQ, with firm size as a control variable. **Methods:** Using four regression models and multiple proxies for FRQ, this study adopts a robust empirical design. **Results:** Findings reveal mixed effects: corporate governance has a positive effect on FRQ in one model; audit quality shows no effect or is negative; financial leverage is insignificant; ESG performance varies from positive, negative, to no effect. Model 2 showed the highest explanatory power, supporting the relevance of ESG and governance to FRQs. **Novelty:** This study introduces a multi-model, multi-proxy framework and diversifies ESG measurement sources to enrich the depth of analysis. **Implications:** For practitioners, ESG engagement and governance compliance signal improved FRQ, guide investment and lending decisions and provide direction for future research.

Keywords: Financial Reporting Quality, Corporate Governance Mechanism, Financial Leverage, Audit Quality, ESG Performance

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INTRODUCTION

Financial reporting has become a prevalent topic in accounting research, as it provides important financial information that helps stakeholders to improve the quality of decision making and fulfil their objectives (Apochi & Mustapha, 2022). Financial reporting quality provides reliable answers that fulfil the interests of external users, especially those who invest funds into the company, such as creditors and investors (Amanamah, 2024; Irwandi & Pamungkas, 2020; Qawqzeh *et al*., 2019; Wicaksono *et al*., 2024). In other words, the quality of financial reporting is the extent to which the financial statements issued by the company fulfil the requirements provided by accounting standards. The substance of financial reporting quality is further supported by the fact that public companies are required to publish their annual financial performance. Investors and creditors, in particular, rely heavily on these financial statements for their decision-making (Apochi & Mustapha, 2022; Irwandi & Pamungkas, 2020). In addition, to guide stakeholders in making the right business decisions, published financial statements must be relevant and in accordance with the actual condition of the company (Abbas *et al*., 2021). This means that financial statements must comply with IFRS (International Financial Reporting Standards), which is a group of accounting standards that play a role in ensuring compliance with how financial transactions are recorded globally (Apochi & Mustapha, 2022). IFRS also requires financial statements to properly disclose important non-financial information that occurs and is not normally included in the financial statements, in a section known as the notes to the financial statements (Kieso *et al*., 2020). This aspect is very important and often overlooked as external users tend to focus only on the reported numbers, which in itself can hide the truth about the company's ability to continue as a going concern. Following IFRS largely opens up opportunities for the economy and capital markets to thrive, as poor decision-making due to lack of financial knowledge will be greatly reduced (Yayangida *et al*., 2023). On the contrary, following IFRS and PSAK, the Indonesian Financial Accounting Standard that adopts IFRS, may result in significant losses that may jeopardise the survival of companies and damage their reputation. Investors and creditors who invested funds will be threatened with losses, companies will lose their image, and the economy will collapse (Scott, 2015). For example, PT Garuda Indonesia Tbk, one of the leading airline companies in Indonesia, was involved in financial statement fraud in 2019, where the company was found to have hidden a net loss of USD 244.95 million in 2018 and instead reported a net profit of USD 809.84 thousand (Ikbal *et al*., 2020). Another example is PT Asuransi Jiwasraya, a company engaged in life insurance, which was found to have committed financial statement fraud by offering high interest and return rates (Alimirruchi & Chariri, 2023). The offer encouraged people to invest in a savings plan known as JS Saving Plan, unknowingly losing their money as the company invested it in low-quality stocks and funds without proper research, causing huge losses to the company and insurance claim holders. Considering all the above evidence of financial statement fraud cases, it is imperative for all companies to demonstrate and implement compliance with IFRS to avoid such incidents. This case also highlights how, when the quality of a company's financial statements is poor, it can jeopardise the company's financial performance and destroy public trust, often leading to bankruptcy and widespread financial difficulties (Özer *et al*., 2024). In addition, reliable and quality financial statements can reduce the cost of capital, increase the chance of obtaining more funding from third parties, and stimulate the capital market, especially for investors and creditors (Amanamah, 2024; Apochi & Mustapha, 2022).

The quality of financial reporting and the things that influence it can be understood through agency theory (Amanamah, 2024; Hasan *et al*., 2022; Irwandi & Pamungkas, 2020; Qawqzeh *et al*., 2019; Yayangida *et al*., 2023), which states that there is often a conflict between the objectives of shareholders (principals) and managers (agents) (Jensen & Meckling, 1976), and stakeholder theory (Şeker & Şengür, 2021), which emphasises the importance of providing reliable information to both internal users, such as shareholders and employees, and external users who are affected by the company's actions (Awa *et al*., 2024). Based on agency theory, this study shows that agency costs give rise to several determinants that are thought to affect financial reporting quality, namely corporate governance mechanisms (Amanamah, 2024; Hasan *et al*., 2022; Irwandi & Pamungkas, 2020; Qawqzeh *et al*., 2019), financial leverage (Amanamah, 2024; Elfageih, 2021; Safdar *et al*., 2023), and audit quality (Amanamah, 2024; Ganesan *et al*., 2024; Qawqzeh *et al*., 2019). At the same time, stakeholder theory helps explain ESG performance, i.e. how well companies look after their stakeholders by engaging in activities that go beyond making money, and this affects the quality of financial reporting. These variables are used in this study because they play a major role in determining the agency costs of companies, as well as providing detailed and transparent non-financial information to ensure that companies comply with ESG practices and enforce positive accountability to stakeholders.

The research model also includes control variables, specifically firm size (Özer *et al*., 2024; Şeker & Şengür, 2021). Firm size, although not directly related to the above-mentioned factors, helps control firms in producing high quality financial statements by acting as a control variable. In addition, financial statements of larger firms usually have greater resource availability and more public exposure, which puts pressure on them to ensure their reports are in accordance with applicable accounting standards (Amanamah, 2024; Handini & Susilo, 2025). Furthermore, agency theory emphasises that as firm resources increase, agency costs are likely to increase due to the greater need for oversight from shareholders.

Previous research shows that corporate governance mechanisms have a positive effect on the quality of financial reporting (Amanamah, 2024; Hasan *et al*., 2022; Qawqzeh *et al*., 2019), except that the component of corporate governance mechanisms, namely institutional ownership, has a negative relationship with financial reporting quality. (Ventura *et al*., 2023) also disagree with this opinion, stating that corporate governance mechanisms do not affect the quality of financial reporting. (Poretti *et al*., 2020) found that financial leverage is positively related to financial reporting quality. However, (Amanamah, 2024) found that financial leverage does not significantly affect financial reporting quality, indicating the need for further research, while (Safdar *et al*., 2023) found that financial leverage negatively affects financial reporting

quality. Audit quality has a positive effect on financial reporting quality (Amanamah, 2024), while (Ganesan *et al.*, 2024) found that audit quality has a negative effect on financial reporting quality when measured by the proxy of audit tenure. In addition, (Sem & Hastuti, 2024) found that audit quality does not affect financial reporting quality, suggesting the need for further research. Finally, it has been found that ESG performance improves financial reporting quality (Şeker & Şengür, 2021). Contrary to (Şeker & Şengür, 2021) research, (Choi & Lee, 2024) found that ESG performance undermines the comparability of financial statements, which is one of the key characteristics that make up true and fair financial statements. These inconsistencies highlight the need for additional academic research focused on analysing financial statement quality.

Given the importance of measuring and implementing financial reporting quality in corporate practice, researchers should continue to dedicate efforts to this particular topic in accounting studies (Amanamah, 2024; Apochi & Mustapha, 2022; Yayangida *et al.*, 2023). However, previous studies have mostly looked at general ways to measure financial reporting quality, such as discretionary accruals (Qawqzeh *et al.*, 2019; Şeker & Şengür, 2021; Yayangida *et al.*, 2023), audit opinion (Rakhman & Wijayana, 2019), or compliance with IFRS (Amanamah, 2024). This research aims to incorporate discretionary accruals and readability, which measures how easy it is to read published information, into the analysis of financial reporting quality. This approach will provide innovation in accounting research and a more in-depth analysis that combines financial and non-financial elements. In addition, ESG-related research often ignores other factors that determine financial reporting quality, which further supports the purpose of this study. Moreover, since many platforms provide ESG performance scores, comparing these scores offers a more in-depth analysis of how ESG performance affects financial reporting quality. Therefore, this study aims to examine whether corporate governance mechanisms, financial leverage, audit quality, and ESG performance jointly affect financial reporting quality, specifically for non-financial companies listed on the Indonesia Stock Exchange.

Agency theory first introduced by (Jensen & Meckling, 1976) explains the relationship between the principal, who is the person in charge, and the agent, who is the person authorised to carry out tasks that help achieve the principal's objectives (Prasastine & Yulianto, 2022; Mardianto & Jaslyn, 2024; Sarniati & Handayani, 2024). Agency theory was chosen because it has become the main theory to explain the phenomena behind many accounting issues, including the determinants of financial reporting quality (Amanamah, 2024; Ganesan *et al.*, 2024; Hasan *et al.*, 2022; Qawqzeh *et al.*, 2019; Şeker & Şengür, 2021; Yayangida *et al.*, 2023). Agency theory is often used to analyse any kind of interaction between two parties, i.e. the principal and the agent, and find the underlying potential problems behind the interaction (Qawqzeh *et al.*, 2019). The company's shareholders act as principals, directing managers, who function as agents, to operate the company on their behalf.

Stakeholder theory attempts to explain the underlying meaning of stakeholders, i.e. those who play a role in influencing how the company operates, as well as those who are affected by the company's end product, either directly or indirectly (Freeman, 2004). This emphasises the need to satisfy those who are affected by the company's actions, as they also contribute to the company's growth (Freeman, 2004). In addition, they are also a key element of the company's success, because when the company performs well, the company's image will improve as stakeholders begin to treat the company positively (Şeker & Şengür, 2021). This sentiment is further reinforced by the company's efforts to contribute to stakeholders, which is often done by ensuring a high ESG score and disclosing the company's efforts and strategic planning to achieve overall long-term sustainability (Şeker & Şengür, 2021).

Corporate Governance Mechanisms and Financial Reporting Quality

Corporate governance mechanisms are an important tool in ensuring excellent financial reporting quality, as companies are run by a board of directors who oversee the management of the company and supervise day-to-day activities to delegate shareholder intentions and attempt to turn them into reality (Ainun & Sari, 2024; Safdar *et al.*, 2023; Hasan & Lestari 2024; Rohman & Suhardianto, 2024; Sari & Setiawan, 2024). This results in a satisfactory corporate governance mechanism with more accurate financial reports and complete information disclosure as the final product (Amanamah, 2024; Tanjung, 2020). According to (Tanjung, 2020), corporate governance mechanisms consist of several factors, which are summarised in Table 1 Corporate Governance Mechanism Index.

[Table 1 about here.]

According to agency theory, corporate governance mechanisms, defined as the way managers act as representatives of shareholders in managing the company, can help align the wishes of shareholders with managers by asking disinterested parties to control the degree of discretion managers have in managing the preparation of financial statements. Shareholders rely heavily on corporate governance mechanisms and thus invest heavily to ensure that the company is run in the right hands thereby improving company performance (Salukh & Soewarno, 2022; Darmawan & Umaimah, 2025; Suroto & Setiadi, 2019). In addition, shareholders need to incentivise managers with allowances and bonuses so that managers maximise company performance (Jensen & Meckling, 1976). Furthermore, shareholders are interested in ensuring proper and systematic management planning and control by investing heavily in hiring a competent, reliable and trustworthy board of directors (Amanamah, 2024), which leads to a positive relationship between the two variables.

Previous research analysing the effect of corporate governance mechanisms on financial reporting quality has been one of the most researched topics in accounting research. Some of the studies used as a comparison include (Salukh & Soewarno, 2022) which states that corporate governance mechanisms are proven to have a positive effect on the quality of financial reporting. In addition, (Safdar *et al.*, 2023) also found that corporate governance mechanisms are positively related to financial reporting quality. Therefore, this study proposes the following hypothesis:

H1: Corporate governance mechanisms have a positive effect on financial reporting quality.

Financial Leverage and Financial Reporting Quality

Financial leverage is one of the main determinants whose influence on financial reporting quality has been investigated several times (Amanamah, 2024). As companies grow and seek more funding, issuing loans is a viable option for businesses (Ravindran & Kengatharan, 2021; Indrayati *et al*., 2024). In addition, lenders seek a higher level of disclosure in the reported financial statements because they need to fully understand the condition of the company that is lending its assets (Poretti *et al*., 2020). This is to ensure that company management allocates creditor funds appropriately. Increased disclosure also provides external parties with a broader view of the company's condition, thereby increasing company transparency and indicating higher financial reporting quality.

According to agency theory, this is based on the premise that since creditors often demand lengthy details about the company's current performance, companies are required to comprehensively disclose their financial status, leading to a decrease in agency problems between shareholders and managers and an improvement in the quality of financial reporting as information asymmetry is reduced (Amanamah, 2024; Ibrahim & Isiaka, 2020). This is because shareholders seek to minimise agency costs by ensuring that managers use resources obtained from debt solely to maximise company performance, offsetting agency costs that would otherwise be high due to high debt ownership (Elfageih, 2021).

Previous research analysing the effect of financial leverage on financial reporting quality has increased due to the company's dependence on debt funding to purchase the required assets. For example, research conducted by (Poretti *et al*., 2020) shows that financial leverage has a positive effect on the quality of financial reporting, which is due to the strict supervision of creditors that leads to more detailed disclosures in financial statements, thereby improving their quality. (Elfageih, 2021) supports this idea by reporting a positive relationship between financial leverage and financial reporting quality. In addition, (Kwanbo, 2020) revealed that financial leverage improves the quality of financial reporting. Financial leverage improves the quality of financial reporting. Therefore, based on the previous explanation, the second hypothesis is formulated as follows:

H2: Financial leverage has a positive effect on financial reporting quality.

Audit Quality and Financial Reporting Quality

Audit quality plays an important role in ensuring the fairness of a company's financial statements. It provides assurance to stakeholders about the quality of financial statements (Amanamah, 2024). Having a trustworthy accounting firm that conducts audits properly helps detect indicators of fraud and errors within the company. Audit quality also indicates the role of an independent party who plays an important role in thoroughly examining the quality of the company's financial statements and internal controls, revealing whether managers have operated the company in accordance with the shareholders' plans. This is very important, given that companies face a much higher risk of producing materially misstated financial statements when unaudited (Amanamah, 2024).

From an agency theory perspective, audit quality helps reduce agency costs borne by shareholders (Amanamah, 2024; Yayangida *et al*., 2023). This is because audit quality provides an opportunity for shareholders to check the company's overall financial performance in a certain period by appointing an accounting firm to process the audit (Yayangida *et al*., 2023; Puspaningsih & Larasati, 2024). In addition, since accounting firms often stand as a neutral party, company management will have fewer opportunities to manipulate the numbers reported in the financial statements (Amanamah, 2024; Fajri & Prabowo, 2024). All this helps in reducing agency costs, as agency theory suggests that shareholders face difficulties in assessing managers' behaviour (Jensen & Meckling, 1976), leading to better financial reporting quality (Qawqzeh *et al*., 2019).

Previous research efforts analysing the impact of audit quality on financial reporting quality are positively significant due to the importance of having audited financial statements to meet regulatory compliance and capital provider requirements. For example, (Amanamah, 2024) reported that audit quality has a positive effect on financial reporting quality, based on the assumption that an extensive audit process often results in better analyses of the company's overall financial health. Another study conducted by (Qawqzeh *et al*., 2019) found that audit quality proved significant in improving financial reporting quality. (Asikin *et al*., 2022) also found that audit quality significantly improves the quality of financial reporting, supporting the research of (Amanamah, 2024) and (Qawqzeh *et al*., 2019). Therefore, the third hypothesis can be structured as follows:

H3: Audit quality has a positive effect on financial reporting quality.

ESG Performance and Financial Reporting Quality

ESG performance encourages companies to contribute positively to sustainability, whose reports can provide solid explanations to describe the phenomena behind financial reporting (Şeker & Şengür, 2021). Shareholders should also maintain acceptable performance that satisfies the company's stakeholders more than financial performance (Velte, 2019). In addition, integrating ESG elements as part of a company's strategic objectives shows that the company endeavours to contribute to achieving long-term sustainability, not just financially (Özer *et al*., 2024; Wati *et al*., 2024; Sany *et al*., 2024). Placing focus on sustainability-oriented activities also improves the quality of financial statements by providing a transparent view to external parties, especially investors and creditors, making it easier to raise capital for business growth (Özer *et al*., 2024; Darlis *et al*., 2024; Sany *et al*., 2024). In addition, the quality of published financial statements will improve as they include extensive disclosures of how the company is performing sustainably, information that is often not reported in financial statements (Özer *et al*., 2024).

Stakeholder theory states that companies should aim to fulfil

stakeholder expectations (Freeman, 2004). This means meeting stakeholders' expectations of the company's operational capability through positive financial growth and outstanding ESG performance. Demanding the company's operational capability by maintaining positive financial growth, as well as outstanding ESG performance, is a must. By doing this, the company's image will increase in value by attracting investors and creditors who always consider ESG aspects when deciding where to invest or lend. High ESG performance also contributes to better financial reporting quality, as it indicates that the company has good ethical values in managing its operations, leading to reduced opportunities for fraudulent practices and manipulation in financial statement preparation practices (Şeker & Şengür, 2021).

The impact of ESG performance on financial statement quality has been investigated several times with mixed results. (Şeker & Şengür, 2021)reported in their study that although ESG performance is positively related to financial reporting quality, the social component (S) of ESG proved to be insignificant. On the other hand, (Özer *et al*., 2024) revealed that ESG performance has a positive impact on financial reporting quality. Therefore, the fourth hypothesis can be made according to this explanation:

H4: ESG performance has a positive effect on financial reporting quality.

METHODS

testing the proposed hypotheses to analyse the effect of corporate governance mechanisms, financial leverage, audit quality, and ESG performance on financial reporting quality. Multiple linear regression will be used to test the cross-section data in this study to determine whether each of the above-mentioned determinants affects the quality of financial reporting. In addition, this study uses four different regression models, with the differences in each model focussing on the proxy of financial reporting quality as the dependent variable and ESG performance as one of the independent variables, working as follows:

Model 1 uses financial reporting quality represented by discretionary accruals and ESG performance represented by ESG score from Morningstar Sustainalytics.

Model 2 uses financial reporting quality represented by discretionary accruals and ESG performance represented by ESG score from Katadata.

Model 3 uses financial reporting quality represented by Gunning's Fog Index and ESG performance represented by ESG score from Morningstar Sustainalytics.

Model 4 uses financial reporting quality represented by Gunning's Fog Index and ESG performance represented by ESG score from Katadata.

Variable Identification, Operational Definition, and Measurement

There are 3 types of variables that will be used in this study, namely dependent variables, independent variables, and control variables. Details of the measurement of each of these variables are described in the table 2.

[Table 2 about here.]

The population used in this study are all Indonesian public companies listed on the Indonesia Stock Exchange (IDX). The sampling technique used in this study was purposive sampling, with the criteria set as follows: 1. Non-financial companies that have been listed on the Indonesia Stock Exchange from 2022 to 2023. 2. Non-financial companies that have published ESG data on Katadata and Morningstar Sustainalytics during 2022-2023. Non-financial companies that have published financial statements and annual reports during 2022-2023.

This study uses multiple linear regression using Eviews 9 and performs descriptive statistics, which is necessary to analyse the characteristics of the data, and hypothesis testing, which tests whether the proposed hypotheses are supported. Due to the large number of factors affecting financial reporting quality as the dependent variable and the use of different proxies for ESG performance to allow for better comparisons, this study used four models. The equation for each model is as follows:

Model 1: $FRQ1_i = \alpha + \beta1CGM_i + \beta2FL_{((i)\ ())} + \beta3AQ_{((i)\ ())} + \beta4ESG1_{((i)\ ())} + \beta5CS_{(i)} + u_i$

Model 2: $FRQ1_i = \alpha + \beta1CGM_i + \beta2FL_i + \beta3AQ_{((i)\ ())} + \beta4ESG2_{(i)} + \beta5CS_{(i)} + u_{(i)}$

Model 3: $FRQ2_i = \alpha + \beta1CGM_{(i)} + \beta2FL_i + \beta3AQ_{(i)} + \beta4ESG1_i + \beta5CS_{(i)} + u_i$

Model 4: $FRQ2_i = \alpha + \beta1CGM_{(i)} + \beta2FL_{((i)\ ())} + \beta3AQ_{((i)\ ())} + \beta4ESG2_{(i)} + \beta5CS_{(i)} + u_i$

Notes:
FRQ1 = Financial Reporting Quality (with discretionary accruals as a proxy)
FRQ2 = Financial Reporting Quality (with GFI as proxy)
α = Constant
β1-5 = Regression Coefficient of Independent Variables
CGM = Corporate Governance Mechanism
FL = Financial Leverage
AQ = Audit Quality
ESG1 = ESG performance (with Morningstar Sustainalytics as data source)
ESG2 = ESG performance (with Katadata as data source)
CS = Company Size
u = Error

RESULTS AND DISCUSSION

This study uses all non-financial companies listed on the Indonesia Stock Exchange from 2022 to 2023. Once the sample was determined, the researcher conducted four regressions based on four different models (FRQ as discretionary accruals and ESG as Morningstar Sustainalytics as model 1, FRQ as discretionary accruals and ESG as Katadata as model 2, FRQ as Gunning Fog's Index and ESG as Morningstar Sustainalytics as model 3, and FRQ as Gunning Fog Index and ESG as Katadata as model 4) to produce more robust findings and analyses. Therefore, based on the research sample selection method below, this study uses 126 samples for model 1, 114 samples for model 2, 126 samples for model

3, and 120 samples for model 4.

To determine the characteristics of the sample data, which consist of financial reporting quality, corporate governance mechanisms, financial leverage, audit quality, and ESG performance, this study uses descriptive statistics to summarise the key information of the sample data.

[Table 3 about here.]

Table 3 shows that the audit quality in models 1, 2, 3, and 4 is different, due to different sample sizes in Table 4.

[Table 4 about here.]

Based on the Table 4, it is interpreted that companies can utilise the concept of accruals to inflate or deflate earnings, which is indicated by positive (increase reported earnings) or negative (decrease reported earnings) values on the measurement of discretionary accruals financial reporting quality. Meanwhile, when financial reporting quality is measured by GFI, it is known that companies tend to signal clear information in their annual reports, which is indicated by a low GFI value, or vice versa (indicated by a high GFI value). However, taken together, companies in models 2 and 4 tend to perform better in terms of their financial reporting quality, as evidenced by having lower average financial reporting quality scores, while models 1 and 3 have worse financial reporting quality. The table also reveals that the standard deviations of financial reporting quality are 0.083, 0.083, 1.817, and 1.656 for each model, respectively, indicating homogeneity, and firms generally have good financial reporting practices except for firms in model 3, which warrants further analysis.

The table reveals that companies behave differently in organising their day-to-day operations. The more effectively firms monitor the corporate governance system, the higher the corporate governance mechanism index, as indicated by the maximum score of 0.866 from all four models, and vice versa, as indicated by the minimum score of 0.400 from all four models. Meanwhile, the averages of corporate governance mechanisms across the four models are 0.714, 0.714, 0.714, and 0.704, indicating strong oversight of corporate board practices. The standard deviations of the four models are 0.078, 0.090, 0.078, and 0.101, respectively, indicating heterogeneity.

Financial leverage indicates how deeply a company relies on debt to finance their operations, invest in long-term assets, or expand into new business sectors. High financial leverage indicates that the main source of the company's assets comes more from creditors than investors, and lower financial leverage indicates greater dependence on investors. Based on the financial leverage values of 1.155, 0.991, 1.155, and 1.027, respectively, companies generally have equivalent capital structures, although the lack of more detailed explanations needs to be addressed. Meanwhile, based on the standard deviation of each model, financial leverage tends to be heterogeneous.

Audit quality usually highlights how thoroughly public accounting firms perform their audit procedures when auditing companies. In this study, a value of 0 indicates that the company is audited by a non-big 4 firm, and 1 if it is audited by a big 4 firm. Based on the audit quality frequency table, Big 4 public accounting firms appear to dominate the market in models 1 and 3. This indicates that companies listed on Morningstar Sustainalytics tend to have greater resources to incur greater audit costs compared to the more diversified Katadata.

ESG performance measures how much impact a company's main operations have on sustainability practices. For the Morningstar Sustainalytics model, a lower ESG score indicates a lower risk of unsustainable business practices, which equates to high ESG performance. Meanwhile, the Katadata model states that a high ESG score indicates good ESG performance. Based on Table 4 above, both the Morningstar Sustainalytics and Katadata models generally indicate a moderate level of ESG performance. The table also provides an overview of the same standard deviation values for each model, which indicates homogeneity.

Company size is measured based on the company's total assets. A higher company size indicates larger total assets held, and conversely, a lower value indicates lower total assets. Based on the table above, companies listed on Morningstar Sustainalytics tend to have significantly larger assets compared to companies listed on Katadata. Meanwhile, when combined, the four models show heterogeneity, as indicated by the large standard deviations in the table.

This study conducted normality test, classical assumption test, goodness-of-fit test, and t-test to test the proposed H1-H4 by performing multiple linear regression on Eviews 9. The results of the normality and heteroscedasticity tests are presented in Table 5, while Table 6 shows the results of the multicollinearity test, and Table 7 presents the autocorrelation test. Table 8 summarises the model fit (goodness-of-fit) test.

[Table 5 about here.]

[Table 6 about here.]

[Table 7 about here.]

[Table 8 about here.]

Based on the regression results, the four research models prove that each model passes the statistical tests which include normality test, heteroscedasticity test (model 1 does not pass but then cured by using the HAC-Newey West estimator to ensure the robustness of the T test), multicollinearity test, and autocorrelation test (model 3 and model 4 do not pass but this test is ignored in this study due to the cross-sectional nature of the regression which assumes the independence of the data so that there is no correlation with the time factor). This study also proves that each model is significant in explaining the phenomenon of financial statement quality, as evidenced by the four models passing the F test, which ensures the robustness and validity of the hypothesis testing results. Meanwhile, based on the R^2test, each model can explain the phenomenon of financial reporting quality by 9.6%, 11%, 13.7%, and 10.8%, respectively, with the remaining percentage explained by variables not mentioned in this study.

[Table 9 about here.]

Based on Table 9, Model 2 shows that H1 is accepted and corporate governance mechanisms have a positive effect on the quality of financial reporting. This is in line with the research of (Salukh & Soewarno, 2022) who agree with the notion that good corporate governance practices can improve the quality of published financial reports. This is mainly because companies that invest in ensuring good corporate governance mechanisms tend to have clearer job responsibilities and a transparent working environment, both of which encourage the improvement of the quality of the company's financial reporting practices. Meanwhile, models 1, 3, and 4 prove that corporate governance mechanisms have no effect on the quality of financial reporting. Although this contradicts the research written by (Salukh & Soewarno, 2022) and (Safdar *et al*., 2023), who reported that corporate governance mechanisms have a positive effect on financial reporting quality, this finding is in line with the research conducted by (Ventura *et al*., 2023), which states that corporate governance mechanisms have no effect on financial reporting quality. This may be because companies focus on other factors that are more impactful and direct in ensuring good financial reporting quality, such as the effectiveness of internal control and strategic management, which are more important than the practice of corporate governance mechanisms. In addition, firms tend to view corporate governance mechanisms only as a tool to fulfil state regulations rather than as a tool to improve the quality of their financial statements, which may lead to actions that do not directly impact the improvement of financial statement quality, such as improving the accuracy of reported accounts by ensuring only accruals required by IFRS are reported in the financial statements or simplifying the readability of the firm's annual report to make it easier to understand. It is also possible that, because Model 2 uses Katadata, Katadata-listed companies feel less urgency to adjust their current corporate governance systems compared to Morningstar Sustainalytics-listed companies as Morningstar Sustainalytics-listed companies have broader exposure globally. In addition, companies listed on Katadata tend to be smaller in terms of size, which may make the practice of corporate governance mechanisms less significant to the quality of published financial statements. Meanwhile, the difference in results regarding how corporate governance mechanisms affect the quality of financial statements may indicate that companies organise how they link corporate governance structures and policies to their financial reporting processes differently. This means that when companies have good corporate governance mechanisms, they also tend to provide higher quality financial statements because they can ensure proper authorisation and oversight when conducting accounting-related processes. Therefore, this study concludes that corporate governance mechanisms have a positive effect on financial statement quality (model 2) or no effect on financial statement quality (models 1, 3, and 4).

When assessing financial leverage, all four models show that financial leverage has no impact on financial reporting quality. This is in line with research conducted by (Amanamah, 2024) who also found that financial leverage has no effect on financial statement quality, although this contradicts H2 and research conducted by (Kwanbo, 2020; Poretti *et al*., 2020; and (Elfageih, 2021) which state that financial leverage has a positive relationship with financial statement quality. The reason for this phenomenon may be that the main party responsible for determining the quality of financial statements is often the company's internal control system, and how companies delegate appropriate responsibilities within their management, rather than how companies manage their debt levels. While it is true that higher debt levels often require a higher amount of disclosure on their annual reports, which should improve the quality of the financial statements, it also puts companies at greater risk if they struggle to meet loan and interest payment deadlines, which may deliberately adjust the loan-related accounts reported in the financial statements to hide their insolvency. This leads to the avoidance of having large amounts of debt, while companies with low debt levels may realise the importance of lower disclosure. In addition, financial leverage mainly discusses a company's dependence on debt funding and often reflects financial data, while management discussion and analysis (MD&A) in annual reports tends to go deeper into how companies analyse their fiscal year performance and formulate upcoming strategies for the following year in written paragraphs, indicating a potential lack of correlation between the two aspects. This may indicate that debt levels have more influence on how companies manage their working capital needs, while the financial reporting process is usually independent of a company's financial leverage. Therefore, it can be concluded that financial leverage does not affect the quality of financial reporting.

Based on the research findings from hypothesis testing, models 1 and 2 reveal that audit quality has no effect on financial reporting quality, which is in accordance with research conducted by (Sem & Hastuti, 2024).The reason may be that all accounting firms have the same audit standards that guide them in performing audit procedures on companies. Adherence to these standards ensures that the quality of the resulting audit is the same between KAPs, so the size of the KAP becomes irrelevant, because all companies tend to get the same treatment in their accrual reporting. Meanwhile, models 3 and 4 are significant and negative to the quality of financial reporting. The results of this study support the research of (Ganesan *et al*., 2024). However, it contradicts research conducted by (Qawqzeh *et al*., 2019; Asikin *et al*., 2022; Amanamah, 2024), all of which state that audit quality improves financial reporting quality. Since most of the companies audited by Big 4 KAPs are large companies, leading to greater public scrutiny, any information they disclose in their annual reports will greatly affect how the public perceives the company. This may cause companies to focus more on the amounts reported on the financial statements or disclosures on the annual report, potentially increasing readability difficulties as more complex wording is generally required to explain the complicated nuances of the information disclosed in their annual report, instead of improving the efficiency of the company's day-to-day operations and the accuracy of how the company prepares their financial statements. The difference in the results of this study suggests that companies have not properly utilised the positive impact that audit firms have in improving the quality of the financial reporting process. Therefore, audit quality does not affect financial reporting quality (models 1 and 2), but may negatively affect financial reporting quality (models 3 and 4).

Based on the results of the hypothesis testing above, models 1

and 4 agree with the opinion that ESG performance has no significant effect on the quality of financial reporting, which indicates the rejection of H4. This is in line with research conducted by (de Ruijter, 2024) which states that earnings quality is not affected by the presence of ESG. This may be due to the difference in the size of the output generated from ESG publications and financial statements. Since ESG is directly related to how companies operate in a way that promotes sustainability and stakeholder value, financial reports are mainly published to attract investors and creditors in the hope of securing future investments and provide an overview of the company's financial position and performance. This may cause company management to focus on both aspects separately, and therefore, less attention is directed towards the idea of integrating ESG elements into the financial reporting process. In contrast, model 2 states that ESG performance is significantly and positively related to financial reporting quality, which is in line with (Şeker & Şengür, 2021) and (Özer *et al*., 2024), leading to the acceptance of H4. This means that companies are more likely to improve their financial reports when they comply with ESG regulations and strive to fulfil stakeholder demands for their contribution to sustainability. When companies realise the importance of having sustainable business processes, they also strive to improve the quality of their financial statements through improving the effectiveness and efficiency of internal controls in the financial reporting process to complement the disclosure of high-quality non-financial information in the form of ESG performance disclosures. Meanwhile, Model 3 found that ESG performance is significant and proven to have a negative effect on the quality of financial statements, which rejects H4. This is in line with research conducted by (Choi & Lee, 2024), which revealed that ESG risks decrease the comparability of financial statements, which is one of the key characteristics of higher quality financial statements. This could be due to the cost constraint theory, which states that companies should not focus on disclosing certain information if the benefits do not outweigh the costs of such disclosure. For example, companies may realise that a large amount of investment will be required to integrate day-to-day operations with ESG-related data and elements. This is often unrelated to the company's strategic goals of improving day-to-day performance and growing the business, which also require considerable funds, as company management may tend to turn to the latter to stabilise and improve company performance rather than focusing on ESG investments. However, the results are largely different among the four models, indicating the need for further academic research on this aspect, as companies need to figure out how they can benefit from providing ESG information while still making the reporting process as effective as possible as they usually do the financial reporting process. Therefore, based on the research findings, ESG performance has no effect (models 1 and 4), a positive effect (model 2), or a negative effect on financial reporting quality (model 3).

Based on the above results, this study reveals that among the four models used in each research model, model 2 provides the best explanation in explaining how each determinant affects the quality of financial reporting. This is indicated by the passing of all tests and the fulfilment of two of the four hypotheses proposed, so that the model is more reliable by investors and creditors in assessing the company's financial statements for decision-making purposes.

CONCLUSION

The quality of financial reporting is critical to the running of the economy, as it guides investors and creditors to make accurate economic decisions, signalling public confidence and economic success. In an attempt to explain what influences the quality of financial reporting, this study analysed the proposed determinants and concluded that corporate governance mechanisms improve the quality of financial reporting in model 2, possibly due to more efficient internal controls, while models 1, 3, and 4 show no relationship, which may be due to the different strategic focus set by companies. Financial leverage does not affect financial statement quality, possibly because firms tend not to focus on debt levels when monitoring their financial reporting processes. Audit quality does not affect financial statement quality, as shown in models 1 and 2, while models 3 and 4 show that audit quality negatively impacts financial statement quality. This indicates that the former result is most likely due to audit procedures being standardised regardless of audit firm size, while the latter result is most likely due to greater pressure on Big 4 firms to disclose complex information, which shifts the focus of audits away from providing solutions to improve the financial reporting process. ESG performance also has mixed results, as models 1 and 4 show that ESG performance does not affect financial statement quality, likely due to the lack of integration between financial reporting and ESG reporting processes. Model 2 suggests that ESG positively influences financial statement quality, mainly due to the tendency for better financial reporting processes as companies better understand the importance of reporting transparency. However, Model 3 states that ESG performance negatively affects financial reporting quality, which is most likely due to the cost constraint effect. Finally, when choosing which model to use, investors and creditors should favour Model 2 as it is the most robust model in explaining the determinants affecting financial reporting quality.

From an agency theory perspective, this study indicates that companies still have agency problems when implementing how they run their companies and benefit from financial audits, which indicates the need for further examination of how companies can improve their financial reporting processes from good corporate practices and value-added assurance statements provided by auditors. Meanwhile, from a stakeholder theory perspective, there is an urgency to utilise ESG reporting in corporate KPIs to improve financial reporting processes in an effective, efficient and cost-effective manner, as these two aspects often complement each other by providing financial reports, supported by non-financial data, to stakeholders. Addressing these two viewpoints will ensure that companies can provide a holistic view of their overall business performance for accurate decision-making purposes.

During the making of this study, the authors suggest, from an academic point of view, future academic research should try to include more variables in the form of market-related elements as independent variables and control variables to provide more insight into the determinants. Academic authors should also use ESG performance measures that can extend the data period, which may result in more robust research models. In addition, it also guides further academic research to focus more on using

more robust research models and proxies, such as expanding more variables not used in this study and increasing the timeframe to monitor the effectiveness of financial reporting over a broader period of time. Thus, the research gaps discussed in this study can be filled and also innovate on potential areas that can increase the rigour of academic research that analyses the quality of financial reporting. Meanwhile, from the practical side, the authors also encourage companies, especially upper management, to strive to improve their financial reporting processes so that the published financial statements are of high quality, presenting a true and fair view of the company's financial position and performance, especially for investors and creditors. The elements that make up the quality of financial statements and non-financial information, such as corporate governance, financial leverage, audit quality, and ESG performance, also need to be considered to help make informed decisions. Therefore, this study hopes that stakeholders can assess how companies contribute to overall long-term sustainability, including high-quality financial statements.

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***Table 1** / Corporate Governance Mechanism Index*

No	CGM Component	Measurement
1	Code of ethics	A dummy variable of 1 if the company has a code of ethics, zero if otherwise
2	Anti-corruption	A dummy variable of 1 if the company has an anti-corruption policy, zero if otherwise
3	Insider Trading	A dummy variable of 1 is assigned if the company has an anti-insider trading policy, and zero otherwise.
4	Largest shareholder	A dummy variable of 1 if the most significant shareholder has less than 50% ownership, zero if otherwise
5	Free Float	A dummy variable of 1 is given if non-controlling interests own at least 7.5% of voting rights, zero if otherwise.
6	Employee Share Ownership	A dummy variable of 1 is assigned if an employee share ownership program exists, and zero if it does not.
7	Corporate Sustainability Report (CSR)	A dummy variable of 1 is assigned if there is disclosure of CSR elements in the published annual report, and zero otherwise.
8	Whistleblower	A dummy variable of 1 is assigned if the company has an established whistleblowing mechanism, and zero otherwise.
9	Sanctions	A dummy variable of 1 if there is disclosure of any sanction on stock market regulation breach, zero if otherwise
10	Big Four auditor	A dummy variable of 1 if the company is audited by a Big 4 company, zero if otherwise
11	Ultimate beneficiary shareholders' disclosure	A dummy variable of 1 if the company discloses the ultimate beneficiary shareholders, zero if otherwise
12	Independent Director	A dummy variable of 1 is assigned if the company has more than one independent director, and zero otherwise.
13	Independent Commissioner	A dummy variable of 1 is assigned if the percentage of independent commissioners on the board exceeds 30%; otherwise, it is assigned a value of 0.
14	Director Board Size	A dummy variable of 1 is given if the board comprises 5 to 9 directors and the company's board of directors > data mean + 2 standard deviations, zero if otherwise.
15	Commissioner Board Size	A dummy variable of 1 is assigned if the board comprises 4 to 8 commissioners and the company's board of commissioners exceeds the data mean by two standard deviations; 0 otherwise.

Source: (Tanjung, 2020)

***Table 2** / Variable Measurement*

Variable	Desc	Measurement
Dependent variable:		
FRQ	Financial reporting quality	1. Discretionary accruals Step 1: $TA_{i,t} = (\Delta CA_{i,t} - \Delta Cash_{i,t}) - (\Delta CL_{i,t} - \Delta STDEBT_{i,t})$ $-DEP_{i,t} - AMOR_{i,t}$ Information: $\Delta CA_{i,t}$ = change in current assets for company i in year t $\Delta Cash_{i,t}$ = change in cash and cash equivalents for company i in year t $\Delta CL_{i,t}$ = change in current liabilities for company i in year t $\Delta STDEBT_{i,t}$ = change in current maturity of short-term debt for company i in year t $\Delta DEP_{i,t}$ = depreciation expense for company i in year t $\Delta AMOR_{i,t}$ = amortization expense for company i in year t Step 2: $DA_{i,t} = \alpha_0 \frac{1}{A_{i,t-1}} + \alpha_1 \frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} + \alpha_2 \frac{PPE_{i,t}}{A_{i,t-1}}$ $+\alpha_3 \, x \, ROA_{i,t-1} + \varepsilon_{i,t}$ Information: $DA_{i,t}$ = non-discretionary accruals $A_{i,t-1}$ = lagged total assets, or total assets for company i in year t-1 α_0 = constant α_{1-3} = regression coefficient of the independent variable $(\Delta REV)_{i,t}$ = changes in net revenues for company i in year t $(\Delta REC)_{i,t}$ = changes net accounts receivable for company i in year t $(PPE)_{i,t}$ = gross property, plant, and equipment for company i in year t $(ROA)_{i,t-1}$ = return on assets (net income after tax divided by total assets) for company i in year t-1 $\varepsilon_{i,t}$ = error term Step 3: $DA_{i,t} = \frac{TA_{i,t}}{A_{i,t-1}} - NDA_{i,t}$ Information: $DA_{i,t}$ = discretionary accruals $\frac{TA_{i,t}}{A_{i,t-1}}$ = total accruals scaled by lagged total assets $NDA_{i,t}$ = non-discretionary accruals 2. GFI readability score (in the annual report's management and discussion analysis)
Independent Variables:		
CGM	Corporate governance mechanism	Corporate governance mechanism index score
FL	Financial leverage	Debt-to-equity ratio (DER)
AQ	Audit quality	Dummy variable of 1 if the company is audited by a Big 4 accounting firm, zero if otherwise
ESG	ESG performance	1. ESG score from Katadata 2. ESG score from Morningstar Sustainalytics
Control Variables:		
CS	Company size	Natural logarithm of total assets

***Table 3** / Audit Quality Table of Frequency*

Model	Var.	Desc.	Score	F	%
1	AQ	Companies not audited by any of the Big 4 companies	0	30	24%
		Companies audited by any of the Big 4 companies	1	96	76%
		Total		126	100%
2	AQ	Companies not audited by any of the Big 4 companies	0	58	51%
		Companies audited by any of the Big 4 companies	1	56	49%
		Total		114	100%
3	AQ	Companies not audited by any of the Big 4 companies	0	30	24%
		Companies audited by any of the Big 4 companies	1	96	76%
		Total		126	100%
4	AQ	Companies not audited by any of the Big 4 companies	0	64	53%
		Companies audited by any of the Big 4 companies	1	56	47%
		Total		120	100%

***Table 4** / Descriptive Statistics*

	Var.	N	Min.	Max.	Avg.	Std.
1	FRQ	126	-0.102	0.340	0.083	0.083
	CGM	126	0.533	0.866	0.714	0.078
	FL	126	0.031	7.239	1.155	1.319
	ESG	126	8.800	58.11	30.03	10.63
	CS	126	28.98	33.73	31.29	0.981
2	FRQ	114	-0.171	0.249	0.025	0.083
	CGM	114	0.533	0.866	0.714	0.090
	FL	114	0.102	5.876	0.991	1.039
	ESG	114	33.20	81.58	57.60	11.03
	CS	114	24.65	32.85	29.76	1.613
3	FRQ	126	9.184	19.24	14.97	1.817
	CGM	126	0.533	0.866	0.714	0.078
	FL	126	0.031	7.239	1.155	1.319
	ESG	126	8.800	58.11	30.03	10.63
	CS	126	28.98	33.73	31.29	0.981
4	FRQ	120	9.184	18.83	14.35	1.656
	CGM	120	0.400	0.866	0.704	0.101
	FL	120	0.102	5.876	1.027	1.089
	ESG	120	31.51	81.58	56.60	10.83
	CS	120	24.65	32.85	29.70	1.621

FRQ = Financial Reporting Quality (model 1 and 2 use discretionary accruals as proxy, model 3 and 4 use GFI as proxy)
CGM = Corporate Governance Mechanism
FL = Financial Leverage
ESG = Environmental Social Governance Performance (model 1 and 3 use Morningstar Sustainalytics as proxy, model 2 and 4 use Katadata as proxy)
CS = Company Size

***Table 5** / Normality Test & Heteroscedasticity Test*

Model	Normality Test		Heteroscedasticity Test	
	Probability	**Conclusion**	**Probability**	**Conclusion**
Model 1	0.199	Normally distributed	0.0176	Heteroscedasticity*)
Model 2	0.240	Normally distributed	0.7185	Homoscedasticity
Model 3	0.732	Normally distributed	0.8131	Homoscedasticity
Model 4	0.961	Normally distributed	0.2780	Homoscedasticity

*) Using HAC Newey-West to test hypotheses

Source: data processed in 2024

***Table 6** / Multicollinearity Test*

Var.	Centered VIF (Model)				Conclusion
	1	2	3	4	
CGM	1.097	1.583	1.050	1.548	No multicollinearity
FL	1.107	1.146	1.179	1.184	No multicollinearity
AQ	1.304	1.519	1.119	1.502	No multicollinearity
ESG	1.658	1.264	1.082	1.313	No multicollinearity
CS	2.038	1.355	1.111	1.402	No multicollinearity

Source: data processed in 2024

***Table 7** / Autocorrelation Test*

Model	dU	dW	4-dU	Conclusion
Model 1	1.7923	2.1239	2.2077	No autocorrelation
Model 2	1.7869	1.9191	2.2131	No autocorrelation
Model 3	1.7923	1.2532	2.2077	No autocorrelation
Model 4	1.7896	1.3112	2.2104	No autocorrelation

Source: data processed in 2024

***Table 8** / Goodness of Fit Test*

Model	R-square	F sig.	Conclusion
Model 1	0.096796	0.030	Model Fit
Model 2	0.110569	0.025	Model Fit
Model 3	0.137659	0.002	Model Fit
Model 4	0.108898	0.020	Model Fit

Source: data processed in 2024

***Table 9** / Hypotheses Testing*

Model	Var.	Coef.	Prob.	Conclusion
	CGM	-0.058	0.53	H1 is not supported
	FL	-0.010	0.16	H2 is not supported
Model 1	AQ	-0.039	0.09	H3 is not supported
	ESG	0.001	0.17	H4 is not supported
	CS	-0.015	0.02	Significant
	CGM	-0.221	0.04	H1 is supported
	FL	-0.013	0.08	H2 is not supported
Model 2	AQ	0.031	0.10	H3 is not supported
	ESG	-0.001	0.05	H4 is supported
	CS	0.001	0.83	Not significant
	CGM	-3.692	0.07	H1 is not supported
	FL	0.136	0.28	H2 is not supported
Model 3	AQ	1.034	0.00	H3 is not supported
	ESG	-0.033	0.03	H4 is not supported
	CS	0.280	0.09	Significant
	CGM	-0.853	0.63	H1 is not supported
	FL	0.275	0.06	H2 is not supported
Model 4	AQ	0.843	0.02	H3 is not supported
	ESG	0.026	0.09	H4 is not supported
	CS	-0.062	0.56	Not significant

Significant at p-value 5%
CGM = corporate governance mechanism
FL = financial leverage
AQ = audit quality
ESG = environmental social governance performance
CS = company size