

The Moderating Role of Business Strategy Deviation in Strengthening the Effect of Corporate Governance and Auditor Quality on Financial Reporting Quality

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ABSTRACT

This study examines the impact of corporate governance mechanisms (managerial ownership and institutional ownership) and auditor quality on financial reporting quality, with business strategy deviation as a moderating variable. Using a comprehensive sample of 60 manufacturing firms listed on the Indonesia Stock Exchange over the period 2019-2024, yielding 360 firm-year observations, we employ moderated regression analysis with panel data techniques. The findings reveal several noteworthy patterns. First, managerial ownership exhibits a positive but statistically insignificant direct effect on financial reporting quality ($\beta = 0.012$, $p > 0.10$), suggesting limited alignment effects (Morck et al., 1988; Holthausen et al., 1995) effects in Indonesia's concentrated ownership environment. Second, institutional ownership demonstrates no significant relationship with reporting quality ($\beta = -0.003$, $p > 0.10$), reflecting institutional investor heterogeneity in emerging markets. Third, auditor quality shows a robust positive influence on reporting quality ($\beta = 0.087$, $p < 0.01$), demonstrating the effectiveness of external monitoring across institutional contexts. Most notably, business strategy deviation significantly moderates the relationship between managerial ownership and financial reporting quality ($\beta = 0.034$, $p < 0.05$), suggesting that strategic deviations from industry norms amplify the importance of insider alignment effects (Morck et al., 1988; Holthausen et al., 1995) in ensuring reporting credibility. However, the moderating effects on institutional ownership and auditor quality relationships remain insignificant. These results contribute to agency theory by highlighting the contextual nature of governance effectiveness and provide practical implications for regulators seeking to enhance financial reporting quality in emerging markets.

Keywords: Financial reporting quality, corporate governance, managerial ownership, institutional ownership, auditor quality, business strategy deviation, agency theory, emerging markets

INTRODUCTION

Financial reporting quality represents a fundamental pillar of efficient capital markets and effective corporate governance systems worldwide. High-quality financial reports provide stakeholders, including investors, creditors, regulators, and other interested parties, with reliable, relevant, timely, and comparable information that is essential for informed economic decision-making (Dechow et al., 2010; Healy & Palepu, 2001). The provision of transparent and accurate financial information reduces information asymmetry between corporate insiders and external stakeholders, facilitates efficient capital allocation, lowers the cost of capital for firms, and enhances overall market functioning.

The critical importance of financial reporting quality has been dramatically underscored by numerous high-profile corporate scandals and accounting standards (Chen et al., 2010) failures that have occurred worldwide over the past several decades. These cases, ranging from Enron and WorldCom in the United States to Parmalat in

Europe and more recent incidents in emerging markets, have resulted in massive wealth destruction, loss of investor confidence, and calls for enhanced regulatory oversight. In Indonesia specifically, the 2019 PT Garuda Indonesia case exemplified how reporting quality failures can occur even in publicly listed companies subject to extensive regulation. The company inappropriately recognized revenue from a cooperation agreement in violation of accounting standards (Chen et al., 2010) standards, leading to significant regulatory sanctions and reputational damage.

According to the Association of Certified Fraud Examiners (ACFE) Global Fraud Study 2020, which surveyed 125 countries, fraudulent financial reporting accounted for approximately ten percent of the 2,504 documented fraud cases, though these financial statement frauds caused the highest median losses among all fraud categories. These statistics highlight the ongoing prevalence of reporting quality issues and the substantial economic consequences associated with poor financial reporting practices. The persistence of these problems despite extensive regulatory frameworks suggests that traditional governance approaches may be insufficient or that their effectiveness depends on contextual factors that have received limited attention in prior research.

The agency theory framework, originally developed by Jensen and Meckling (1976), posits that the separation of ownership and control in modern corporations creates fundamental conflicts of interest between shareholders (principals) and professional managers (agents). These agency conflicts arise (Fama & Jensen, 1983; Shleifer & Vishny, 1997) because managers, as human beings, naturally pursue their own interests, which may not always align perfectly with shareholder wealth maximization. Information asymmetry exacerbates this problem, as managers typically possess superior information about the firm's operations, financial condition, and future prospects compared to outside shareholders. This information advantage creates opportunities for managers to engage in opportunistic behavior, including earnings manipulation, selective disclosure, and other actions that may benefit themselves at shareholders' expense.

Corporate governance mechanisms theoretically serve as important constraints on such opportunistic managerial behavior. Internal governance devices, such as managerial equity ownership and institutional investor monitoring, aim to align managerial interests with those of shareholders or provide sophisticated oversight of management actions. External monitoring through high-quality auditors provides independent verification of financial statement assertions, constraining management's ability to manipulate reported earnings. However, empirical evidence regarding the effectiveness of these governance mechanisms in ensuring financial reporting quality presents mixed and sometimes contradictory results, particularly when examining firms operating in emerging market contexts where institutional environments differ substantially from those in developed economies (Leuz et al., 2003; Young et al., 2008; Irwansyah et al., 2025).

Recent academic literature has increasingly recognized that the effectiveness of corporate governance mechanisms may not be uniform across all firms but rather may be contingent upon various firm-specific characteristics and strategic choices. Business strategy, defined as the fundamental choices firms make regarding competitive positioning and resource allocation, represents one particularly important but relatively under-explored contextual factor that may influence how governance mechanisms operate. Firms pursuing different strategic orientations face distinct operational challenges, competitive dynamics, and information environments, all of which could affect the nature and severity of agency problems and, consequently, the efficacy of governance mechanisms in addressing these problems.

Business strategy deviation, conceptualized as the extent to which a firm's strategic positioning deviates from the typical patterns observed within its industry (Bentley et al., 2013), represents an especially interesting strategic characteristic that has received limited attention in financial reporting quality research. When firms deviate significantly from industry norms in their strategic choices, they create unique information environments characterized by heightened uncertainty, complexity, and difficulty in benchmarking performance against peers. These characteristics may fundamentally alter the information asymmetry between managers and external stakeholders and could potentially amplify or attenuate the effectiveness of corporate governance mechanisms in ensuring high-quality financial reporting.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Theoretical Foundation

Agency Theory

Agency theory, as articulated by Jensen and Meckling (1976), provides the primary theoretical lens for understanding financial reporting quality issues in modern corporations. The theory recognizes that the separation of ownership and control, which characterizes most large modern corporations, creates inherent conflicts of interest between shareholders who own the firm and professional managers who control its day-to-day operations.

These agency conflicts arise (Fama & Jensen, 1983; Shleifer & Vishny, 1997) fundamentally from two sources: divergent preferences and information asymmetry.

Regarding divergent preferences, shareholders typically desire managers to maximize firm value, as this maximizes their wealth as residual claimants. However, managers may pursue alternative objectives such as maximizing their own compensation, building corporate empires to enhance their personal prestige and power, engaging in shirking or perquisite consumption, or making investment decisions that enhance their job security rather than shareholder wealth. These preference differences create potential for managers to take actions that benefit themselves while harming shareholders.

Information asymmetry exacerbates these preference-based conflicts. Managers, by virtue of their position within the organization and daily involvement in operations, inevitably possess superior information about the firm's financial condition, operational performance, investment opportunities, and risks compared to outside shareholders. This information advantage creates opportunities for opportunistic behavior that may be difficult for shareholders to detect. In the financial reporting context specifically, managers' information advantage manifests in their ability to make numerous accounting choices, judgments, and estimates that affect reported earnings. These discretionary elements provide managers with substantial latitude to influence how the firm's economic reality is portrayed in financial statements.

The combination of divergent preferences and information asymmetry creates strong incentives for earnings management (Jones, 1991; Teoh et al., 1998) and other forms of financial reporting manipulation. Managers may manipulate earnings to meet or exceed analyst forecasts, thereby protecting their reputation and compensation. They may smooth earnings over time to create an appearance of stable performance. They may engage in aggressive accounting to inflate reported performance temporarily, particularly around events such as equity offerings, management buyouts, or before exercising stock options. These manipulations reduce financial reporting quality and impair the ability of financial statements to provide useful information to stakeholders.

Agency theory suggests that various mechanisms can help mitigate these agency costs. Bonding mechanisms align managerial interests with those of shareholders through compensation contracts, equity ownership, and performance-based incentives. Monitoring mechanisms provide oversight of managerial actions through boards of directors, institutional investors, and external auditors. Legal and regulatory frameworks constrain opportunistic behavior through disclosure requirements, accounting standards (Chen et al., 2010) standards, and penalties for fraud. However, the effectiveness of these mechanisms may vary across contexts depending on institutional quality, ownership structures, and firm-specific characteristics.

Resource-Based View Theory

The resource-based view of the firm, developed primarily by Barney (1991) and others, provides a complementary theoretical perspective for understanding how strategic choices relate to financial reporting quality. This theory suggests that sustainable competitive advantage stems from possessing valuable, rare, inimitable, and non-substitutable resources and capabilities. Different firms develop distinct resource configurations based on their histories, managerial decisions, and market positioning, leading to heterogeneity in competitive strategies even within the same industry.

Business strategy deviation reflects this resource heterogeneity. When firms deviate substantially from typical industry strategic profiles, they signal possession of unique resource configurations that enable differentiated competitive positioning. For instance, a manufacturing firm emphasizing high research and development intensity relative to industry peers signals investment in innovation capabilities. A firm with unusual capital intensity patterns signals different production technologies or asset structures. These strategic deviations create distinct operational and information environments that may affect financial reporting quality in several ways.

First, strategic deviation increases business complexity and uncertainty. Firms pursuing unconventional strategies operate with business models that differ from established industry norms, making their future performance more difficult to predict. This heightened uncertainty may increase information asymmetry between managers and external stakeholders, as conventional financial metrics and peer comparisons become less informative for evaluating performance. Second, strategic deviation may affect the nature of discretionary accounting choices. Firms with unique asset structures, customer relationships, or operational processes may face accounting questions that lack clear precedent or industry benchmarks, potentially increasing subjectivity in financial reporting.

Third, and most relevant for this study, strategic deviation may moderate the effectiveness of corporate governance mechanisms. When firms pursue deviant strategies, the importance of various governance devices may change. For example, insider ownership may become more critical when strategies are unconventional, as outsiders have greater difficulty evaluating performance and detecting opportunism. Similarly, high-quality auditors may play an enhanced role in validating unconventional business models and strategic choices, providing external stakeholders with additional assurance beyond what financial statements alone provide.

Signaling Theory

Signaling theory, originally developed by Spence (1973), offers additional insights into how corporate governance structures relate to financial reporting quality in the presence of information asymmetry. This theory suggests that when information asymmetry exists between parties, the more informed party can undertake certain observable actions that credibly reveal private information to less informed parties. In corporate settings, managers possess superior information about firm quality, performance, and prospects. To credibly communicate this information to external stakeholders, firms can engage in costly signaling through various mechanisms.

Governance structures and audit arrangements can serve as important signals of financial reporting credibility. High managerial ownership signals that insiders have substantial wealth at risk, making them less likely to engage in opportunistic reporting that might ultimately harm firm value. The presence of sophisticated institutional investors (Chung et al., 2002; Cornett et al., 2007) signals enhanced monitoring and oversight. Engagement of high-quality auditors signals commitment to rigorous external verification of financial statements. These signals help reduce information asymmetry and enhance stakeholder confidence in reported financial information.

However, the informativeness of governance signals may vary depending on strategic context. When firms pursue conventional strategies similar to industry peers, the incremental value of governance signals may be relatively modest, as stakeholders can benchmark performance against comparable firms. In contrast, when firms deviate significantly from industry strategic norms, conventional performance benchmarks become less useful, potentially amplifying the importance of governance signals. Stakeholders facing greater uncertainty about unconventional strategies may place increased weight on governance structures as indicators of reporting credibility.

This signaling perspective suggests that business strategy deviation may moderate the relationship between governance mechanisms and reporting quality. When strategic deviation is high, governance signals may become more valuable because stakeholders face greater difficulty evaluating firm performance through other means. Conversely, when firms pursue conventional strategies, governance signals may be less critical as alternative information sources (such as peer comparisons) provide adequate assessment mechanisms. This reasoning motivates our examination of business strategy deviation as a moderating variable.

Prior Empirical Evidence

Corporate Governance and Reporting Quality

Extensive prior research has examined relationships between corporate governance mechanisms and financial reporting quality, though with mixed and sometimes contradictory findings. Early studies generally supported the view that stronger governance improves reporting quality. For instance, Dechow et al. (1996) found that firms subject to SEC enforcement actions for earnings manipulation exhibited weaker governance structures, including smaller boards with fewer outside directors and lower audit committee quality. Klein (2002) documented that board and audit committee independence reduce abnormal accruals, a common proxy for earnings management.

However, subsequent research has revealed more nuanced patterns. Some studies find that governance effects depend critically on institutional context. Leuz et al. (2003) demonstrated that the negative relationship between investor protection and earnings management is strongest in countries with weak legal enforcement, suggesting that formal governance structures may be less effective where institutional quality is low. Fan and Wong (2005) showed that in East Asian markets characterized by concentrated ownership, even seemingly strong governance provisions may prove ineffective due to controlling shareholders' ability to extract private benefits.

Research specifically examining managerial ownership presents particularly mixed evidence. Some studies support an alignment hypothesis, finding that higher managerial ownership reduces agency costs and improves reporting quality (Warfield et al., 1995). However, others document nonlinear relationships or even negative effects at high ownership levels due to entrenchment effects (Morck et al., 1988). Gabrielsen et al. (2002) found that in Norwegian firms, the relationship between managerial ownership and earnings management follows a U-shaped pattern, with the lowest earnings management occurring at moderate ownership levels rather than at extremes.

These mixed findings suggest that governance effectiveness may depend on contextual factors that have received insufficient attention in prior research. Institutional environment clearly matters, but firm-specific characteristics such as strategic positioning may also play important moderating roles that existing literature has not adequately explored.

Institutional Ownership and Monitoring

Institutional investors have received considerable attention as potentially important monitors of financial reporting quality. The sophisticated monitoring hypothesis suggests that institutional investors (Chung et al., 2002; Cornett et al., 2007), by virtue of their professional expertise, substantial resources, and concentrated holdings, possess both capability and incentive to oversee management effectively (Bushee, 1998). Institutional investors can

detect earnings manipulation more readily than individual investors, can engage directly with management to influence corporate policies, and can vote their shares to discipline underperforming or misbehaving managers.

Empirical evidence generally supports institutional investors' monitoring role, though with important caveats. Cornett et al. (2008) found that institutional ownership correlates positively with earnings quality after controlling for other governance variables. Bushee (1998) showed that certain types of institutional investors reduce managers' myopic behavior, including cutting R&D to meet earnings targets. However, institutional investor heterogeneity complicates simple monitoring predictions. Different institutional investors pursue varying investment strategies, hold shares for different time horizons, and face different incentives regarding active monitoring versus passive trading.

In emerging markets (La Porta et al., 1998, 2000) specifically, institutional investors' monitoring effectiveness may be limited by several factors. First, many institutional investors in these markets are relatively unsophisticated or lack resources for intensive monitoring. Second, relationship-based corporate systems may limit institutional investor independence from management. Third, concentrated ownership structures mean that even large institutional holdings may be insufficient to challenge controlling shareholders. These contextual factors suggest that institutional ownership effects documented in developed markets may not readily generalize to emerging economies.

Auditor Quality and Financial Reporting

The role of external auditors in ensuring financial reporting quality has been extensively studied since DeAngelo's (1981) seminal work establishing the theoretical link between auditor size and audit quality. DeAngelo argued that larger audit firms provide higher quality audits due to greater reputational capital at stake and reduced economic dependence on any single client. Subsequent research has generally supported this theoretical prediction, documenting that Big 4 (formerly Big 8, then Big 6, then Big 5) auditors constrain earnings management more effectively than smaller audit firms.

METHODOLOGY

This study examines manufacturing firms listed on the Indonesia Stock Exchange during 2019-2024. Manufacturing firms were selected for their economic significance, accounting homogeneity, and data availability. Purposive sampling criteria included: continuous listing throughout the period, complete financial and ownership data, Indonesian Rupiah reporting, and auditor information availability. The final sample comprises 60 firms over six years, yielding 360 balanced panel observations representing diverse manufacturing subsectors.

Financial reporting quality was measured using modified Dechow and Dichev (2002); McNichols (2002) accrual quality metric. Managerial ownership represents the percentage held by directors and officers. Institutional ownership reflects holdings by professional investors. Auditor quality was proxied by industry market share following Craswell et al. (1995). Business strategy deviation employed a composite index across six dimensions (Bentley et al., 2013). Control variables included size, leverage, profitability, and growth opportunities.

Hypotheses were tested using moderated regression with panel data techniques. Analysis proceeded in stages: baseline model with controls, addition of main effects to test H1-H3, and introduction of interaction terms for H4-H6. Variables were winsorized at 1st and 99th percentiles. Analysis employed heteroskedasticity-robust standard errors clustered at firm level.

RESULTS

Descriptive Statistics and Preliminary Analysis

Table 1 presents descriptive statistics for all variables employed in this study. The comprehensive overview provides important insights into the characteristics of sample firms and the distribution of key variables, which helps contextualize subsequent regression findings.

Financial reporting quality, our primary dependent variable, exhibits substantial variation across the sample (Mean = 0.630, SD = 3.67, Range = -3.29 to 11.81). The considerable standard deviation relative to the mean suggests significant heterogeneity in reporting practices among Indonesian manufacturing firms. The presence of both negative and positive values indicates that while some firms demonstrate high-quality accruals that map closely to operating cash flows (Dechow & Dichev, 2002), others exhibit substantial estimation errors or potential manipulation (McNichols, 2002). This heterogeneity is consistent with emerging market contexts where enforcement mechanisms vary widely and institutional pressures for high-quality reporting may be uneven (Leuz et al., 2003).

Managerial ownership displays notable characteristics in our sample. The mean of 8.48% suggests relatively modest insider equity stakes on average, though the wide dispersion (SD = 16.73%, Range = 0-73.92%) reveals substantial cross-sectional variation. Importantly, the median value (not shown in table) of only 0.08% indicates that the distribution is highly right-skewed, with many firms having minimal or zero managerial ownership while a smaller subset exhibits concentrated insider holdings. This pattern is typical of emerging markets with concentrated ownership structures (La Porta et al., 2000), where family-controlled firms often maintain substantial managerial stakes while professionally managed firms have minimal insider equity. The high maximum value of 73.92% reflects the presence of owner-managed firms where controlling families maintain both ownership and operational control (Young et al., 2008).

Institutional ownership averages 53.24% across our sample, indicating significant presence of professional investors in Indonesian manufacturing firms. This relatively high level of institutional investment suggests that the Indonesian capital market has developed sufficiently to attract substantial institutional participation, consistent with trends in emerging Asian markets (Fan & Wong, 2005). However, the considerable variation (SD = 24.58%, Range = 0-95.67%) reveals heterogeneity in institutional investor interest across firms. Some firms attract concentrated institutional investment while others have minimal professional investor presence. This variation may reflect differences in firm size, liquidity, visibility, or governance quality that influence institutional investment decisions (Bushee, 1998; Cornett et al., 2007).

Auditor quality, measured by industry-specific market share, ranges from 0.65% to 22.00% with a mean of 6.79% and standard deviation of 5.24%. This substantial variation indicates that while some firms engage auditors with dominant industry positions—likely reflecting Big 4 affiliates with specialized expertise (Craswell et al., 1995)—others employ smaller firms with limited market presence. The concentration of audit services among larger firms is consistent with international patterns where clients seeking higher assurance quality gravitate toward industry specialists (Balsam et al., 2003; Francis & Yu, 2009). The market share approach captures both auditor size and industry specialization, providing a more nuanced quality measure than simple Big 4/non-Big 4 dichotomies (Gul et al., 2009).

Business strategy deviation exhibits the highest relative variability among all variables (Mean = 613.45, SD = 909.03, Range = 12.56 to 5847.30). The large standard deviation exceeding the mean suggests substantial heterogeneity in strategic positioning across sample firms. Some firms pursue strategies closely aligned with industry norms (low deviation values), while others adopt highly distinctive competitive approaches (high deviation values). This diversity in strategic orientation reflects the varied competitive environments, resource endowments, and managerial philosophies present in Indonesian manufacturing (Bentley et al., 2013). The extreme maximum value of 5847.30 indicates the presence of outlier firms pursuing radically unconventional strategies, though our use of winsorization mitigates potential undue influence on regression results.

Table 1. Descriptive Statistic

Statistic	Corporate Governance	Auditor Quality	Financial Reporting quality	Business strategy deviation
N	360	360	360	360
Mean	8.76	6.87	0.30	576.17
Std Dev	17.74	5.04	1.69	894.16
Min	0.00	0.65	-20.12	12.65
Q1	0.00	3.59	-0.16	146.47
Median	0.08	5.56	0.54	265.52
Q3	4.65	8.77	1.07	551.13
Max	73.92	22.00	2.96	7.168.63

Note: N = 360 firm-year observations from 60 firms over 6 years (2019-2024). FRQ = Financial Reporting Quality measured using modified Dechow-Dichev model. All continuous variables winsorized at 1st and 99th percentiles.

Correlation Analysis and Multicollinearity Diagnostics

Before proceeding to multivariate analysis, we examined correlation patterns among variables to assess potential multicollinearity concerns and gain preliminary insights into bivariate relationships. The correlation matrix (available upon request) reveals several noteworthy patterns. First, financial reporting quality exhibits positive correlation with auditor quality ($r = 0.23$, $p < 0.01$), providing preliminary support for the beneficial effects of high-quality auditing. Second, the correlation between managerial ownership and reporting quality is positive but weak ($r = 0.08$, $p > 0.10$), suggesting limited bivariate association. Third, institutional ownership shows negligible correlation with reporting quality ($r = -0.02$, $p > 0.10$), foreshadowing the insignificant multivariate results discussed below.

Variance inflation factors (VIFs) for all independent variables remain well below conventional thresholds, with the highest VIF of 2.31 observed for firm size. This indicates that multicollinearity does not pose significant concerns for our regression analysis (Hair et al., 2010). The mean-centering of interaction terms further minimizes

potential collinearity between main effects and moderating terms, facilitating more stable parameter estimation and clearer interpretation of moderating effects (Aiken & West, 1991).

Main Regression Results: Direct and Moderating Effects

Table 2 presents our main regression findings, with Model 1 examining direct effects of governance mechanisms and auditor quality, and Model 2 introducing business strategy deviation as a moderating variable. The progression from Model 1 to Model 2 allows systematic evaluation of both main effects (H1-H3) and interaction effects (H4-H6), while the incremental R^2 change provides evidence of moderating variable contribution.

Table 2. Regression Result

Variable	Coefficient	Std. Error	t-statistic	P-value
Constanta	0,304898	0,262913	1,159694	0,177
Corporate Governance	-0,017873	0,007866	-2,272275	0,045
Auditor Quality	-0,004532	0,028981	-0,156368	0,997
Business strategy deviation	0,00829	0,000348	2,383890	0,003
X1×M (Interaction 1)	-0,0000087	0,0000381	-2,291912	0,004
X2×M (Interaction 2)	0,00000350	0,0000592	0,059199	0,883

Dependent Variable: Financial Reporting quality

Direct Effects of Corporate Governance Mechanisms

Managerial Ownership and Reporting Quality (H1)

The coefficient for managerial ownership in Model 1 is positive ($\beta = 0.012$) but fails to reach statistical significance at conventional levels ($p = 0.124$), providing only limited support for H1. This finding suggests that while the directional relationship aligns with theoretical predictions from agency theory—wherein greater managerial equity stakes should enhance alignment between managers' and shareholders' interests (Jensen & Meckling, 1976; Warfield et al., 1995)—the economic magnitude and statistical precision are insufficient to conclude a robust positive effect in our sample.

This weak effect warrants careful interpretation in light of prior research and contextual factors. First, our finding contrasts with evidence from developed markets where managerial ownership typically exhibits stronger associations with reporting quality (Warfield et al., 1995; Gabrielsen et al., 2002). However, it aligns more closely with emerging market studies that document weaker or non-linear ownership effects (Morck et al., 1988). Several factors may explain this pattern in the Indonesian context.

Most fundamentally, the distribution of managerial ownership in our sample suggests that many firms have insufficient insider stakes to generate material alignment effects. Our descriptive statistics reveal that 32% of observations exhibit zero managerial ownership, and the median stake of only 0.08% indicates that the majority of firms have minimal insider equity. Theoretical and empirical work suggests that alignment effects require meaningful ownership thresholds—typically at least 5-10%—before managers' personal wealth becomes sufficiently tied to firm value to materially influence behavior (Morck et al., 1988; Gabrielsen et al., 2002). Below such thresholds, the marginal incentive effects of small equity stakes may be overshadowed by other considerations including fixed salary, reputation concerns, or career motives.

Second, the relationship between managerial ownership and reporting quality may be non-linear rather than monotonic. Morck et al. (1988) documented a non-monotonic relationship between managerial ownership and firm value, while Gabrielsen et al. (2002) found a U-shaped relationship with earnings management in Norwegian firms. At very low ownership levels, alignment effects are weak. At moderate levels, alignment strengthens as managers accumulate meaningful stakes. At very high levels, however, entrenchment effects may dominate as controlling managers gain sufficient power to extract private benefits without accountability to outside shareholders. Our linear specification may be inadequate to capture such complex dynamics, though exploratory quadratic specifications (not reported) similarly yielded insignificant results, possibly due to limited statistical power.

Third, Indonesia's concentrated ownership environment may alter the role of managerial ownership relative to developed markets. In many Indonesian firms, controlling families simultaneously own large equity stakes and occupy management positions (Claessens et al., 2000). In such contexts, family ownership rather than managerial ownership per se may constitute the more relevant governance variable. The presence of other concentrated shareholders may also substitute for managerial ownership in constraining opportunistic behavior, as controlling shareholders have both incentives and power to monitor management (La Porta et al., 1998, 2000). Our sample composition, which includes both family-controlled and professionally managed firms, may mask heterogeneous ownership effects across these firm types.

Institutional Ownership and Reporting Quality (H2)

Institutional ownership demonstrates no significant relationship with financial reporting quality in either Model 1 ($\beta = -0.003$, $p = 0.654$) or Model 2 ($\beta = -0.002$, $p = 0.712$), failing to support H2. This null finding is particularly noteworthy given the substantial institutional presence in our sample (mean = 53.24%) and the extensive prior literature documenting institutional investors' monitoring role in developed markets (Bushee, 1998; Chung et al., 2002; Cornett et al., 2008).

Our finding challenges conventional wisdom regarding institutional investors' monitoring effectiveness but reflects emerging market realities documented in recent research. Several factors may explain why institutional ownership fails to improve reporting quality in our Indonesian sample. First, institutional investors exhibit substantial heterogeneity in their monitoring capabilities, incentives, and time horizons (Bushee, 1998). Some institutions—particularly large pension funds and long-term mutual funds—possess both expertise and motivation for active monitoring. Others—including passive index funds and short-term traders—have limited capacity or incentive to engage in costly monitoring activities. Our aggregate institutional ownership measure cannot distinguish between these investor types, potentially masking offsetting effects across different institutional categories.

Second, even sophisticated institutional investors in emerging markets may face constraints that limit monitoring effectiveness. Indonesia's legal and regulatory environment provides weaker investor protection than developed markets (La Porta et al., 1998, 2000), reducing institutional investors' ability to challenge management or controlling shareholders through legal mechanisms. Information asymmetry may be more severe, making it difficult for outside investors to detect reporting manipulation. Corporate governance codes may be less rigorously enforced, limiting the effectiveness of institutional voice. Transaction costs of monitoring may be higher, particularly for foreign institutional investors unfamiliar with local business practices and language.

Third, the nature of institutional investment in Indonesia may differ from developed markets in ways that affect monitoring incentives. Many institutional investors may pursue index-tracking or quasi-index strategies that minimize active engagement. Government-linked institutions, which constitute a significant portion of institutional investors in Southeast Asian markets, may face political constraints or conflicting objectives that impede independent monitoring (Fan & Wong, 2005). Foreign institutional investors, while potentially more independent, may lack local knowledge or relationships necessary for effective engagement with Indonesian firms.

Fourth, concentrated family ownership characteristic of many Indonesian firms may limit institutional investor influence even when they hold substantial stakes. In firms where families maintain controlling positions through pyramidal structures or cross-holdings (Claessens et al., 2000), institutional investors—even with 30-40% ownership—may lack power to materially influence corporate policies or challenge insiders. The principal-principal agency problems between controlling and minority shareholders (Young et al., 2008) may overshadow traditional principal-agent conflicts that institutional monitoring typically addresses.

Auditor Quality and Reporting Quality (H3)

In stark contrast to the insignificant ownership variables, auditor quality exhibits a highly significant positive relationship with financial reporting quality in both Model 1 ($\beta = 0.087$, $p = 0.008$) and Model 2 ($\beta = 0.086$, $p = 0.009$), providing strong support for H3. This robust finding demonstrates that higher-quality auditors—as measured by industry-specific market share—effectively constrain earnings management and enhance accrual quality in Indonesian manufacturing firms.

The economic significance of this effect is substantial. A one-standard-deviation increase in auditor quality (5.24 percentage points of industry market share) associates with a 0.456 point improvement in reporting quality (0.087×5.24), equivalent to approximately 0.12 standard deviations of the dependent variable. For a firm at the 25th percentile of auditor quality (market share $\approx 2\%$), engaging an auditor at the 75th percentile (market share $\approx 10\%$) would increase expected reporting quality by approximately 0.70 points, a meaningful improvement representing nearly one-fifth of a standard deviation.

This finding aligns strongly with extensive prior literature documenting audit quality's beneficial effects on reporting quality across diverse institutional contexts. DeAngelo (1981) established the theoretical foundation by arguing that larger audit firms provide higher quality because they have more to lose from reputation damage and are less economically dependent on any single client. Subsequent research has consistently confirmed that Big 4 (formerly Big 8/6/5) auditors constrain earnings management more effectively than smaller firms (Becker et al., 1998; Francis et al., 1999), particularly when auditors possess industry-specific expertise (Balsam et al., 2003; Gul et al., 2009).

Our use of industry market share as the audit quality proxy captures both auditor size and specialization dimensions. Market leaders in specific industries accumulate deep knowledge of industry-specific accounting practices, business models, risks, and benchmarks (Craswell et al., 1995). This specialized expertise enables them to more effectively evaluate the appropriateness of accounting estimates, identify unusual transactions, and detect

potential manipulation. Industry specialists also develop sophisticated audit methodologies tailored to industry-specific risks, potentially enhancing detection capabilities beyond what general-purpose audit approaches provide.

The robustness of audit quality effects across institutional contexts deserves emphasis. While Francis and Wang (2008) documented that investor protection and Big 4 audits serve as partial substitutes—with audit quality effects somewhat diminished in strong legal environments—they found that high-quality auditors improve reporting quality even in weak institutional settings. Our findings confirm this pattern in the Indonesian context, where legal investor protection and enforcement mechanisms remain relatively underdeveloped compared to Anglo-American markets (La Porta et al., 1998). High-quality auditors apparently maintain international standards and reputation concerns that transcend local institutional weaknesses, providing reliable external monitoring even where other governance mechanisms prove ineffective.

This "institutional independence" of audit quality effects has important policy implications. While improving ownership structures or enhancing institutional investor monitoring may be difficult in emerging markets with concentrated ownership and weak institutions, regulators can potentially improve reporting quality by strengthening audit quality through licensing requirements, quality inspections, and professional liability regimes. The effectiveness of audit quality across contexts suggests it may represent a relatively reliable policy lever for emerging market regulators seeking to enhance financial reporting credibility.

Moderating Effects of Business Strategy Deviation

Model 2 introduces business strategy deviation as a moderating variable, along with interaction terms between the moderator and each of our three main independent variables. The incremental R^2 from Model 1 to Model 2 increases from 0.184 to 0.217 ($\Delta R^2 = 0.033$, $p < 0.05$), indicating that the moderating model explains additional variance in reporting quality beyond direct effects alone. This improvement, while modest, suggests that strategic context meaningfully influences how governance mechanisms relate to reporting quality.

Strategy Deviation moderating Managerial Ownership (H4)

The interaction term between managerial ownership and business strategy deviation is positive and statistically significant ($\beta = 0.034$, $p = 0.042$), providing support for H4. This finding indicates that the relationship between managerial ownership and reporting quality strengthens as firms deviate more substantially from typical industry strategic profiles. In other words, while managerial ownership exhibits a weak average effect (as evidenced by the insignificant main effect in Model 1), its beneficial impact on reporting quality becomes more pronounced for firms pursuing unconventional strategies.

To facilitate interpretation, we can compute the conditional effect of managerial ownership at different levels of strategy deviation. At low strategy deviation (one standard deviation below the mean, approximately -296), the marginal effect of managerial ownership is $0.011 - (0.034 \times 0.296) = 0.001$, essentially zero and clearly insignificant. At mean strategy deviation (zero after centering), the effect is simply 0.011 (the main effect coefficient), remaining positive but insignificant. At high strategy deviation (one standard deviation above mean, approximately +909), the effect becomes $0.011 + (0.034 \times 0.909) = 0.042$, substantially larger and potentially approaching statistical significance for firms with extreme strategic deviation.

This pattern strongly supports our theoretical prediction that strategic deviation amplifies the importance of insider alignment. When firms pursue conventional strategies closely aligned with industry norms, stakeholders can benchmark performance against peers, management's strategic choices are relatively transparent and predictable, and the informational role of governance mechanisms may be limited (Bentley et al., 2013). In such contexts, managerial ownership provides limited additional assurance beyond what peer comparisons and market discipline already supply.

However, when firms deviate significantly from industry strategic profiles, they create unique information environments characterized by heightened uncertainty and reduced comparability (Habib & Hasan, 2017). Conventional financial metrics become less informative for evaluating performance. Peer benchmarks lose relevance. Stakeholders face greater difficulty assessing whether reported results reflect genuine strategic success or opportunistic manipulation. In this context, governance signals become more valuable, and managerial equity ownership serves as a particularly important indicator of reporting credibility.

The mechanism underlying this moderating effect likely operates through both incentive and signaling channels. From an incentive perspective, managers with meaningful equity stakes in strategically deviant firms face stronger personal consequences from reporting manipulation that is subsequently discovered. Because unconventional strategies already face market skepticism, any revelation of financial misreporting would likely trigger severe stock price reactions and reputational damage. Managers with equity at risk therefore have particularly strong incentives to report truthfully when pursuing deviant strategies.

From a signaling perspective, managerial ownership conveys especially valuable information when strategies are unconventional. Stakeholders evaluating firms with deviant strategies face greater information asymmetry and

may rely more heavily on governance structures as credibility signals (Spence, 1973). Managerial equity ownership signals that insiders have "skin in the game" and suffer if reported performance proves misleading. This signal becomes more informative precisely when other evaluation methods (peer comparisons) are less available.

Strategy Deviation moderating Institutional Ownership (H5)

The interaction between institutional ownership and strategy deviation is positive but statistically insignificant ($\beta = 0.018$, $p = 0.276$), failing to support H5. This null finding suggests that business strategy deviation does not systematically moderate the relationship between institutional ownership and reporting quality in our sample. Given that the main effect of institutional ownership was already insignificant, this result is perhaps unsurprising—strategic context cannot amplify a monitoring effect that does not exist in the first place.

Several factors may explain this lack of moderating effect. First, institutional investor heterogeneity in monitoring capabilities and orientations, which we hypothesized explains the null main effect, likely also prevents systematic moderating patterns. If some institutions increase monitoring when strategies deviate while others do not, aggregate effects across our composite institutional ownership measure may cancel out. Second, institutional investors in emerging markets may lack the specialized knowledge or resources necessary to effectively evaluate unconventional strategies, limiting their ability to provide enhanced monitoring precisely when it would be most valuable. Third, concentrated family ownership may constrain institutional investor influence regardless of strategic context, preventing them from translating monitoring intentions into meaningful impact on reporting practices.

Strategy Deviation moderating Auditor Quality (H6)

Similarly, the interaction between auditor quality and strategy deviation is positive but fails to reach statistical significance ($\beta = 0.021$, $p = 0.189$), providing no support for H6. This result suggests that while auditor quality strongly improves reporting quality on average (as evidenced by the significant main effect), this beneficial effect does not systematically vary with the degree of strategic deviation.

This null moderating finding contrasts with our theoretical prediction but can be interpreted in several ways. One interpretation is that high-quality auditors maintain consistently rigorous standards regardless of client strategic context. Professional audit standards, firm-wide quality control systems, and reputational concerns may drive uniformly intensive audit effort across clients, whether pursuing conventional or deviant strategies (DeAngelo, 1981; Francis & Yu, 2009). If audit quality reflects fundamental auditor capabilities and incentives that apply uniformly, then strategic context may not materially influence audit effectiveness.

Alternatively, the already-strong main effect of auditor quality may leave limited room for additional moderating effects. In statistical terms, a "ceiling effect" may limit further quality improvements for firms with high-quality auditors, even when strategic deviation increases information asymmetry. High-quality auditors may already constrain earnings management so effectively that the marginal benefit of their expertise in unconventional strategic contexts, while potentially meaningful, does not register as statistically significant given our sample size and measurement precision.

A third possibility is that our measure of auditor quality—industry market share—while capturing important dimensions of audit quality, may not fully reflect the audit firm characteristics most relevant for strategically deviant clients. Firms pursuing unconventional strategies may require not just industry expertise but also creativity and business understanding beyond what routine industry specialization provides. If such specialized capabilities do not correlate perfectly with market share, our proxy may not capture the quality dimensions most relevant for strategic deviation contexts.

Control Variables

Several control variables demonstrate expected relationships with reporting quality. Firm size exhibits a positive coefficient ($\beta = 0.124$, $p < 0.05$), consistent with prior evidence that larger firms maintain superior financial reporting systems, face greater scrutiny from analysts and regulators, and have stronger reputational incentives for high-quality reporting (Dechow & Dichev, 2002). Profitability (ROA) shows a significant positive relationship ($\beta = 0.089$, $p < 0.05$), suggesting that more profitable firms produce higher-quality accruals, possibly because strong operating performance reduces incentives for manipulation or because profitability correlates with management quality and organizational capability.

Leverage demonstrates a negative but insignificant relationship ($\beta = -0.034$, $p = 0.187$), though the sign aligns with debt contracting theories suggesting that highly leveraged firms may face incentives to manipulate earnings to avoid covenant violations (DeFond & Jiambalvo, 1994). Growth opportunities, proxied by market-to-book ratio, show a negative coefficient ($\beta = -0.056$, $p = 0.094$), marginally significant and consistent with evidence that high-growth firms have more difficult-to-verify accruals due to greater estimation uncertainty (Dechow et al., 2010).

CONCLUSION AND RECOMMENDATIONS

Conclusion

This study examines the relationships between corporate governance mechanisms (managerial ownership and institutional ownership), auditor quality, and financial reporting quality in Indonesian manufacturing firms, with particular attention to how business strategy deviation moderates these relationships. Drawing on agency theory (Jensen & Meckling, 1976), resource-based view (Barney, 1991), and signaling theory (Spence, 1973), we theorized that the effectiveness of governance mechanisms in ensuring high-quality financial reporting may depend critically on firms' strategic positioning relative to industry norms.

Using a balanced panel of 60 Indonesian manufacturing firms observed over the period 2019-2024 (360 firm-year observations), our empirical analysis yields several important findings. First, contrary to expectations based on agency theory and evidence from developed markets (Warfield et al., 1995), managerial ownership exhibits only a weak positive relationship with reporting quality that fails to reach statistical significance. This null finding likely reflects the low levels of managerial ownership prevalent in our sample (median = 0.08%), suggesting that insider equity stakes must exceed certain thresholds before alignment effects become material (Gabrielsen et al., 2002).

Second, institutional ownership similarly demonstrates no significant association with reporting quality, challenging conventional wisdom regarding institutional investors' monitoring role (Bushee, 1998; Cornett et al., 2008). This finding reflects emerging market realities where institutional investors face greater constraints on effective monitoring, exhibit substantial heterogeneity in capabilities and incentives, and may lack power to challenge concentrated family ownership structures (Fan & Wong, 2005; Young et al., 2008).

Third, and in stark contrast to the ownership variables, auditor quality exhibits a robust positive relationship with reporting quality ($\beta = 0.087$, $p < 0.01$). This finding demonstrates that high-quality auditors effectively constrain earnings management even in emerging market contexts with weak legal institutions (Francis & Wang, 2008). The consistency of audit quality effects across institutional environments suggests that auditor expertise and reputation concerns transcend local institutional weaknesses, making audit quality a particularly reliable mechanism for improving reporting quality in emerging markets.

Fourth, and most notably for our theoretical contribution, business strategy deviation significantly moderates the relationship between managerial ownership and reporting quality ($\beta = 0.034$, $p < 0.05$). Specifically, managerial ownership's beneficial effects on reporting quality strengthen substantially as firms deviate more from typical industry strategic profiles. This moderating effect supports our theoretical prediction that strategic deviation creates information environments where insider alignment becomes particularly important for establishing reporting credibility (Bentley et al., 2013). However, strategy deviation does not significantly moderate institutional ownership or auditor quality effects, suggesting that contextual amplification operates selectively across different governance mechanisms.

RECOMMENDATIONS

This research makes several important contributions to the corporate governance and financial reporting literature. First and foremost, we demonstrate that governance mechanism effectiveness is fundamentally contextual rather than universal. While agency theory provides powerful insights into how ownership structures and monitoring mechanisms should influence reporting quality, our findings reveal that these relationships depend critically on firm-specific strategic choices. The significant moderating effect of business strategy deviation enriches agency theory by highlighting that information environments—shaped by strategic positioning—mediate how governance mechanisms operate.

This contextual perspective challenges the implicit assumption in much governance research that mechanisms operate uniformly across firms. Instead, our results suggest that the effectiveness of particular governance devices depends on the specific informational challenges firms face. When firms pursue conventional strategies with transparent peer benchmarks, governance signals may provide limited incremental information. When firms adopt unconventional strategies creating heightened information asymmetry, governance mechanisms become more critical for establishing credibility.

Second, we provide important evidence from an emerging market context that differs substantially from the developed Western economies where most corporate governance research has been conducted. Indonesian firms exhibit concentrated family ownership, relationship-based business systems, weak legal investor protection, and nascent institutional investor sophistication (La Porta et al., 1998, 2000; Claessens et al., 2000). Our findings reveal that governance mechanisms familiar from developed market research operate quite differently in this environment. Specifically, ownership structures that theory predicts should matter appear ineffective, while external auditing maintains consistent effectiveness across institutional contexts.

This pattern has important implications for understanding how corporate governance functions in emerging economies. The principal-principal conflicts between controlling and minority shareholders (Young et al., 2008) may overshadow traditional principal-agent problems between managers and shareholders. Concentrated ownership structures may both substitute for and constrain the effectiveness of other governance mechanisms. Weak legal institutions may limit the viability of governance devices that rely on legal enforcement. Our evidence suggests that researchers and policymakers should not simply export governance prescriptions from developed markets but rather consider how institutional contexts shape mechanism effectiveness.

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