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EFFECTS OF REAL EARNINGS MANAGEMENT AND ESG DISCLOSURE ON THE COST OF DEBT WITH POLITICAL CONNECTIONS AS A MODERATING VARIABLE: EVIDENCE FROM LISTED FIRMS IN INDONESIA

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***Abstract*:** *As a crucial financial metric, the cost of debt measures the economic burden that a firm bears when using loans to fund its operations. Using a regression model, this study examines how real earnings management, ESG disclosure, political connections, and several control variables affect the cost of debt within the context of non-financial firms listed on the Indonesia Stock Exchange during the observation period from 2018 to 2021. The results reveal that real earnings management has a significant positive connection with the cost of debt, while ESG Disclosure does not have a significant negative relationship with the cost of debt. As a moderating variable, political connections have been shown to strengthen the positive relationship between real earnings management and the cost of debt. Similarly, political connections also strengthen the negative relationship between ESG Disclosure and the cost of debt. This study highlights the importance of using ethical and transparent financial practices and robust ESG disclosure in managing debt costs. The findings provide insight into the potential benefits of aligning financial and sustainability practices, which may result in improved financial performance, enhanced investor confidence, and reduced business financing costs.*

Keywords: Real Earnings Management, ESG Disclosure, Cost of Debt, Political Connections, Financial Performance

INTRODUCTION

To support their operations, expansion, and/or investment endeavors, firms typically attempt to secure additional funds through stock financing or debt financing. Debt financing refers to the process by which firms raise capital through the issuance of debt instruments, such as bonds, loans, or lines of credit. The expense incurred by the organization for financing through debt is commonly referred to as the cost of debt (Brigham & Houston, 2022). Amid periods of market volatility or economic downturns, such as during the outbreak of the COVID-19 pandemic, financial institutions often impose stricter credit requirements because of heightened risk perceptions. Despite Bank Indonesia's projected stable financial resilience, credit constraints persisted as banks continued to be cautious, and loan demand remained low (Dasih, 2022). Therefore, firms must build creditor trust while prudently controlling debt costs. This is in line with the legitimacy theory, which emphasizes the importance of aligning corporate behavior with public standards.

Junus et al. (2022) have investigated the correlation of politically connected independent commissioners and independent directors with the cost of debt within the Indonesian context and found that businesses with political connections can receive a loan at a lower cost than those without political connections. This finding supports the theory proposed by Faccio et al. (2006), who assert that strong political ties allow companies to negotiate advantages, including investment opportunities, tax exemptions, regulatory protection, and access to

scarce resources. In addition, political connections may affect decisions about earnings management (Ngo & Susnjara, 2017; Sriram et al., 2021) and environmental, social, and governance activities (Alkadi et al., 2022). This is believed to be crucial in identifying the boundaries and circumstances under which certain relationships between ESG disclosure and earnings management may influence the cost of debt.

Previous studies (Suminar & Nadi, 2020; Beiruth et al., 2021; Liu, 2022; Puspita & Utami, 2022; Liu, 2023) have indicated that a firm's earnings management may have a significant impact on its debt costs. This is due to contractual obligations—such as periodic interest payments—held by debt holders. Another study conducted by Khuong et al. (2021) on listed firms in Vietnam has concluded that a higher real earnings management (REM) leads to an increase in the cost of debt. This confirms the result of Kim et al. (2020), who investigated the effects of real earnings management on the cost of debt in 18 countries. These findings support the argument that the positive relationship between REM and the cost of debt becomes more prominent as each country's bond market matures. This is because bond markets with greater maturity facilitate the detection and valuation of corporate REM prices by bondholders in related countries.

Another factor widely believed to affect the cost of debt is Environmental, Social, and Governance (ESG) disclosure. According to the legitimacy theory, firms should expand the extent of their disclosure of sustainability-related information by adhering to relevant regulations on disclosure (Eliwa et al., 2021; Vitolla & Raimo, 2018). One of the most significant contributions of ESG disclosure by a firm is that it lowers the cost of debt by reducing information asymmetries in agency relationships between the firm and its capital providers (stocks and debts), thereby enabling investors to more accurately assess the firm’s risks (Vitolla & Raimo, 2018).

Although numerous studies have documented the impact of ESG disclosure on the cost of debt, the degree of this impact will vary depending on the conditions of each country. According to Eliwa et al. (2021), the effect of ESG practices on the cost of debt is influenced by the country's stakeholders, suggesting that this effect is greater in nations where the community is more prevalent. This demonstrates how civil society may evaluate ESG practices as potential drivers of business behavior (Deegan, 2017).

Despite the growing interest in this topic, the effects of real earnings management and environmental, social, and governance (ESG) disclosure on the cost of debt during the COVID-19 pandemic era have received scant attention. Therefore, this study examines whether firms with real earnings management pay higher borrowing costs because of existing concerns about the reliability of their financial information. In addition, this study investigates the impact of ESG disclosure on the cost of debt, which refers to the interest rate or return that lenders or investors anticipate for debt financing. Furthermore, this study also explores how political connections moderate the relationships between real earnings management, ESG disclosure, and the cost of debt within the context of non-financial listed firms in Indonesia.

THEORETICAL FRAMEWORK AND HYPOTHESES

Real Earnings Management and the Cost of Debt

Earnings management may impair earnings quality and increase information asymmetry, affecting how external investors—such as prospective lenders and other creditors—make decisions about providing resources to the company. Because Real Earnings Management (REM) distorts cash flow by manipulating actual operations, increases earnings noise or errors, and lowers investor expectations for future cash flow levels, it is regarded more negatively than Accrual Earnings Management (AEM).

The REM method can be detrimental to the firm's long-term profitability and competitive advantages (Cohen & Zarowin, 2010; Zang, 2012) as it conceals the firm's unmanaged earnings and estimates deviations from normal cash flow from operations, production costs, discretionary spending, R&D spending, and sales manipulation (Habib, 2023). A study by Khuong et al. (2021) has demonstrated how real earnings management affects the cost of debt in two different ways. First, integrating REM with actual business activities—such as production, sales, and investment—can distort future cash flow levels. For instance, extending credit terms would increase revenue in the current period. Second, REM can increase the risk of bad debt and reduce future cash flow for operations and investments. Kim et al. (2020) provided additional evidence in support of these hypotheses by using a sample of 14,654 observations across 18 countries from 1987 to 2013. Therefore, the first hypothesis is proposed as follows.
Hypothesis 1 (H1): There is a positive relationship between Real Earnings Management and the cost of debt financing for businesses.

ESG Disclosure and the Cost of Debt

According to the legitimacy theory, firms constantly strive to be perceived as operating within the boundaries and norms of their respective societies. To boost their legitimacy, businesses should adopt practices that impact societal evaluation, such as social and environmental practices, through actual activities and/or disclosure. In the context of Indonesia, ESG practices have been regulated in the Regulation of the Indonesia Financial Services Authority (*Otoritas Jasa Keuangan*/OJK) Number 51/POJK.03/2017, which governs the implementation of sustainable finance for financial services institutions, issuers, and public firms. Issued in 2017, this regulation mandates financial service institutions, issuers, and public corporations to create sustainability reports by January 2019 and submit them to the OJK.

This new perspective motivates lending institutions to integrate sustainability factors into the creditworthiness evaluation. Raimo et al. (2021) have shown how more transparent firms that employ more extensive ESG disclosure policies have better access to third-party financial resources with more favorable terms. In European Union (EU)-based businesses, organizations can reduce the interest rates on their loans by improving their environmental, social, and governance (ESG) performance and degree of disclosure (Eliwa et al., 2021).

Several studies (Eliwa et al., 2021; Raimo et al., 2021; Lavin & Montecinos-Pearce, 2022; Dhoraisingam Samuel et al., 2022) have reported the negative relationship between ESG disclosure and the cost of debt, demonstrating that lending institutions and policymakers are highly concerned about ESG disclosure. Other studies, on the other hand, find insignificant or even a positive relationship between ESG practices and the cost of debt (Hoepner et al., 2016; Erragragui, 2018; Duong & Huang, 2022; Puspita & Utami, 2022). These conflicting findings imply that the benefits of adopting ESG practices vary by region for various businesses. However, it can be confirmed that greater ESG disclosure is associated with fewer information asymmetries between borrowing firms and lending institutions. Thus, the second hypothesis is proposed as follows.

Hypothesis 2 (H2). There is a negative relationship between ESG disclosure and the cost of debt financing for businesses.

Moderating Role of Political Connections on the Cost of Debt

According to Faccio et al. (2006), businesses with strong political relations can negotiate benefits, including investment opportunities, tax exemptions, regulatory protection, and access to scarce resources. Several studies have suggested that internal political relationships impact firm value. This can enhance a firm's performance (Han & Zhang, 2018) and boost potential investors' confidence in financing the firm (Maaloul et al., 2018), ultimately resulting in a low cost of debt (Chkir et al., 2020; Tee, 2018).

Politically connected firms in Hong Kong have been discussed by Bliss et al. (2018), who provided evidence that interest rates charged by lenders to politically connected firms are significantly lower than those without political connections. This suggests that politically connected firms can use their influence and authority to negotiate lower interest rates. These findings align with another study conducted by Junus et al. (2022), which noted that political connections are standardized in Indonesian listed firms by appointing individuals with government ties to the firm's organizational structure as commissioners and directors. The context of Indonesia continued to evolve when conglomerate entrepreneurs began to use their enormous resources to participate in political activities by establishing political parties and/or implementing other strategies to increase their power.

Several studies have shown that banks are increasingly lending to politically connected businesses because these connections are a reliable indicator of their ability to extend credit (Cheng & Wu, 2019; Khaw et al., 2019), even when they are struggling to do so. This implies that debts channeled by creditors to politically connected firms will have a larger chance of being repaid, even in the event of a financial crisis. Therefore, the following hypotheses are proposed:

Hypothesis 3 (H3): Political connections weaken the positive relationship between Real Earnings Management and Cost of Debt.

Hypothesis 4 (H4): Political connections strengthen the negative relationship between ESG Disclosure and Cost of Debt.

This study explored earnings management and ESG disclosure as the independent variables and the cost of debt as the dependent variable, with political connections as the moderating variable. In addition, firm size, market-to-book ratio, profitability, leverage, and interest coverage were used as control variables. The summary of operational variables can be seen in Table 1.

Table 1. Summary of Operational Variables

Variable	Symbol	Measurement	References
Independent Variables:			
Earnings Management	REM_{it}	*Abn_CFO, Abn_Prod, Abn_Discexp*	Roychowdhury (2006)
ESG Disclosure	$ESGD_{it+1}$	ESG Disclosure	Huber et al. (2017); Eliwa et al. (2021)
Moderating Variable:			
Politically Connected Listed Firms	*PCON_LF*	Dummy variable: 1 if the firm has political connections; 0 if otherwise.	Faccio et al. (2006); Habib et al. (2017); Pascual-Fuster and Crespí-Cladera (2018); Shin et al. (2018); Tihanyi et al. (2019); Harymawan (2020)
Dependent Variables:			
Cost of Debt	COD_{it+1}	Annual net weighted average (WACC) cost of debt	Caragnano et al. (2020); Maaloul et al. (2023)
Control Variables:			
Firm Size	$SIZE_{it}$	Natural logarithm of total assets	Tanin et al. (2024)
Market to Book Ratio	MTB_{it}	Ratio of market capitalization to total book value	Kim et al. (2020); Maaloul et al. (2023)
Profitability	ROA_{it}	Ratio of net income to total assets	Persakis and Iatridis (2017); Tanin et al. (2024)
Leverage	LEV_{it}	Ratio of long-term debt to total assets	Kim et al. (2020); Tanin et al. (2024)
Interest Coverage	IC_{it}	EBITDA by total interest expense	Erragragui (2018); Eliwa et al. (2021)

Source: Processed by Author

RESEARCH METHODS

Sample Selection

The population of this study consists of all non-financial firms publicly listed on the Indonesia Stock Exchange (IDX) throughout the observation period from 2018 to 2021. As of December 31, 2022, the IDX has listed 873 firms operating within the non-financial sector. After excluding financial firms and those with missing data, the final sample comprises 69 firms, resulting in a balanced panel of 276 observations from 2018 to 2021. Table 2 displays the distribution of the sample size.

Table 2. Research Sample

Criteria	N
Companies listed on the IDX as of December 2022	873
Elimination:	
Companies listed on the IDX after December 31, 2017	(325)
Companies engaged in the financial sector	(106)
Companies with insufficient information or data elements	(373)
Number of companies used in the study	**69**
Years of Observations (2018–2021)	4
Number of Observations	**276**

Source: Processed data from www.idx.go.id

Measurement of Variables

Calculation of the cost of debt (COD_{it+1})

This study utilized the Bloomberg database to estimate the cost of debt as the weighted average cost of debt for the security, using data on government bond rates, a debt adjustment factor, and the proportions of short-term and long-term debt. The cost of debt was calculated using the following formula:

$$COD_{it+1} = \left[\left[\left(\frac{SD}{TD}\right) X(CS\ x\ AF)\right] + \left[\left(\frac{LD}{TD}\right) x\ (CL\ x\ AF)\right]\right] X[1 - TR] \qquad (1)$$

where,

SD = short-term debt; TD = total debt; CS = pre-tax cost of short-term debt; AF = debt adjustment factor; LD = long-term debt; CL = pre-tax cost of long-term debt; and TR = tax effective rate.

Estimation of the real earnings management magnitude

Roychowdhury (2006) calculates the value of three types of real earnings management using abnormal operational cash flows (CFO), abnormal production costs (PROD), and abnormal discretionary expenses (Discexp). For the measurement of the abnormal levels of CFO, the standard level of cash flow from operations was estimated through a regression model (2):

$$\frac{CFO_{i.t}}{TA_{i,t-1}} = \alpha_0 \frac{1}{TA_{t-1}} + \alpha_1 \frac{SALES_{i,t}}{TA_{i,t-1}} + \alpha_2 \frac{\Delta SALES_{i,t}}{TA_{i,t-1}} \epsilon_{i,t} \qquad (2)$$

where $CFO_{i.t}$ is the operating cash flow for year t; $TA_{i,t-1}$ is the total assets for year t-1; $SALES_{i,t}$ is the total sales for year t; and $\Delta SALES_{i,t}$ is the change in total sales for year t.

Abnormal levels of CFO ($\epsilon_{i,t}$) were determined as the difference between reported and anticipated operating cash flows. This model, however, only reflects the proportion of $\epsilon_{i,t}$ to assets in year t-1. Therefore, to accurately measure discretionary items, $\epsilon_{i,t}$ must be multiplied by assets in year t-1. The positive value of $\epsilon_{i,t}$ from model (2) suggests that firms utilize abnormal operating cash flows as a means of earnings management to increase their adjusted income (i.e., higher sales). Conversely, a negative value indicates that firms employ abnormal operating cash flows as a means of earnings management to reduce their adjusted income (i.e., lower sales).

Another way to manipulate earnings is through overproduction, which cuts indirect costs incurred and the cost of products sold. Production costs have been described in previous studies as a linear function of sales and fluctuations in sales (Roychowdhury, 2006; Cohen & Zarowin, 2010; Zang, 2012; Ge & Kim, 2014). The normal level of production costs was estimated using a regression model (3):

$$\frac{Prod_{i.t}}{TA_{i,t-1}} = \alpha_0 \frac{1}{TA_{t-1}} + \alpha_1 \frac{SALES_{i,t}}{TA_{i,t-1}} + \alpha_2 \frac{\Delta SALES_{i,t}}{TA_{i,t-1}} + \alpha_3 \frac{\Delta SALES_{it-1}}{TA_{i,t-1}} + \epsilon_{i,t} \qquad (3)$$

where $Prod_{i.t}$ denotes the total cost of products sold and the change in inventory for year t.

One way to modify earnings through alterations in actual operational activities is by reducing discretionary expenses. In accordance with the country-year regression model, the standard levels of discretionary expenses were estimated, and then the residual was identified as abnormal discretionary expenses. The standard level of discretionary expenses was calculated using the model proposed by Ge and Kim (2014) as follows.

$$\frac{DisExp_{i.t}}{TA_{i,t-1}} = \alpha_0 \frac{1}{TA_{t-1}} + \alpha_1 \frac{SALES_{i,t-1}}{TA_{i,t-1}} + \epsilon_{i,t} \qquad (4)$$

where $DisExp_{i.t}$ is the aggregate of Research and Development (R&D) expenditures and Selling, General, and Administrative (SG&A) expenditures during year t.

The residuals from the respective regressions indicate an abnormal level of REM_{it} activities. In accordance with Cohen and Zarowin (2010), a comprehensive proxy for real earnings management (REM_{it}) was developed by combining its three measures. To achieve uniformity, the magnitude of REM_{it} must be standardized, because the sign of the three measures shows a divergent trajectory. Initially, the coefficients of Abn_CFO and Abn_DisExp should be multiplied by -1 before adding them to Abn_Prod. The REM_{it} proxies are therefore comparable since they represent unitless fractions of assets that can be aggregated.

ESG disclosure ($ESGD_{it+1}$)

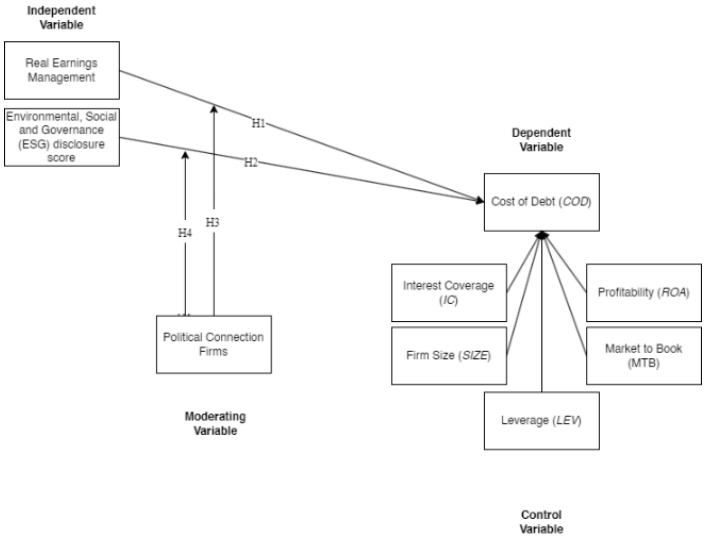
In this study, Bloomberg's ESG Disclosure ($ESGD_{it}$) was utilized to assess the extent to which a firm discloses its ESG performance. The scale for this measurement is 0 to 100, where 0 represents the lowest ESG disclosure, and 100 is the highest. Thus, $ESGD_{it}$ reflects the cumulative score for firm i on the dimensions E, S, and G throughout year t.

Assessments of political connections

Based on prior studies summarized in Table 1, the political connection variable was measured using the following criteria:

1. If any director or commissioner is also a member of a political party, a member of the legislative (parliament) or executive (cabinet) branch, a government official, including military personnel;
2. If any director or commissioner is a former member of the legislative or executive branch or a former government official, including military personnel;
3. If any shareholder owning over 10% of the shares is a member of a political party, has ties to top politicians, or is a current or former government official, including military personnel.

Politically connected listed firms are measured by a dummy variable based on specific criteria, with a minimum score of 0 for a non-politically connected firm and a maximum score of 1 for a politically connected firm. The conceptual framework of the research is illustrated in Figure 1.



Source: Processed by Author

Figure 1. Conceptual Framework

RESULTS AND DISCUSSION

Results

Descriptive analysis

To evaluate the characteristics of the research sample, a descriptive analysis was performed by summarizing key statistical measures, including the mean, median, standard deviation, and minimum and maximum values of each variable. The results are shown in Table 3.

Table 3. Descriptive Statistics of Variables

Variable	Obs	Mean	Median	Std. dev.	Min	Max
COD_{it+1}	276	6.3623	6.3548	1.7259	2.4444	12.6636
REM_{it}	276	1.23E-16	0.0302	0.2841	-1.0955	1.3280
$ESGD_{it+1}$	276	43.5180	43.7331	11.3024	18.2275	73.8658
$SIZE_{it}$	276	31.0806	31.0792	1.0071	27.2553	33.5372
ROA_{it}	276	5.3181	4.0422	7.6552	-16.6274	46.2933
LEV_{it}	276	0.1713	0.1538	0.1477	0	0.6740
IC_{it}	276	52.4043	6.6780	194.2036	-2.5631	1825.581
MTB_{it}	276	4.3079	2.9919	6.5718	0.6065	63.58127
CFO_{it}	276	0.0993	0.0783	0.1046	-0.2714	0.5478
$PCON\_LF_{It+1}$	276	0.8043	1	0.3974	0	1

Source: Processed by Author

Preliminary analysis

The integrity and reliability of the data used in this study were verified using the Gaussian assumption test. The outcomes are presented in Table 4, which provides a comprehensive summary of the test results and potential solutions for any identified issues.

Table 4. Gaussian Assumption Test Results

Test	Test Result	Robustness
Normality Test	Data distribution is not normal.	Sample above 100 using the Central Limit Theorem
Multicollinearity Test	There is no multicollinearity issue.	-
Autocorrelation Test	There is an autocorrelation issue.	Standard error using white cross-section/white diagonal
Heteroscedasticity Test	There is a heteroscedasticity issue.	Using the Weighted Least Squares Method

Source: Processed by Author

The next examination involved selecting the best model. After conducting tests to determine the regression model, the fixed effect model (FEM) was chosen for use in this study.

Estimation results

Tests were performed to select the optimal model for this study, with FEM emerging as the most suitable model for both model 1 and model 2, based on the test results. Table 5 provides a complete explanation of the models used in this study.

Table 5. Hypothesis Test Results

Hyphotesis	Flow	Coefficient	Two-tailed p-value	One-tailed p-value	Conclusion
H1	Cost of Debt -> Real Earnings Management	0.6376	0.0596	0.0298**	Accepted
H2	Cost of Debt -> ESG Disclosure	-0.0198	0.6099	0.30495	Rejected
H3	Cost of Debt -> Real Earnings Management (Moderated by Political Connections)	0.2551	0.5704	0.2852	Rejected
H4	Cost of Debt -> ESG Disclosure (Moderated by Political Connections)	-0.0563	0.0192	0.0096***	Accepted

Note: ***p-value <0.01; **p-value < 0.05
Source: Processed by Author

Discussions

Effects of real earnings management on the cost of debt

The results of the tests carried out in this study demonstrate that real earnings management (REM) has a significantly positive relationship with the cost of debt. This supports the findings of prior studies by Kim et al. (2020) and Khuong et al. (2021), which indicate that the higher a firm's level of REM, the greater the cost of debt assigned

by creditors or banks. This relationship most likely results from the impact of REM activity on cash flow through alterations in operational processes, which increases earnings noise or errors and lowers investor expectations for future cash flow levels. This approach deviates from ideal business operations, obscures the firm's unmanaged earnings, and may adversely affect the firm's long-term profitability and competitive advantages (Cohen & Zarowin, 2010; Zang, 2012).

The management's inclination towards engaging in REM is exacerbated by the firm's financial difficulties during the COVID-19 pandemic. In this regard, managers can alter their net income in a secure and efficient alternative method by using REM to manipulate accounting results in financial statements (Zang, 2012). Consequently, capital market investors may factor the negative impact of REM on earnings quality and firm risk into the cost of debt. In the context of the stakeholder theory, REM raises ethical concerns because it can damage the relationships and trust of businesses' stakeholders.

Effects of ESG disclosure on the cost of debt

The test outcomes reveal that ESG disclosure does not have a significantly negative relationship with the cost of debt. This indicates that stakeholders—i.e., creditors, lending institutions, and banks—have not responded to the firm's ESG disclosures by reducing its cost of debt. These results align with the findings of Hoepner et al. (2016), Burger (2022), and Puspita and Utami (2022), but contradict those of another study by Eliwa et al. (2021). Several factors are believed to account for these differences among research findings and hypotheses, including geographic location, sample size, economic conditions, and maturity implementation. Conditions unique to each country will determine how significantly ESG disclosure affects the cost of debt. This is demonstrated by this study, which focuses on Indonesia, where the implementation of ESG disclosure is still relatively new. The fact that the community of stakeholders is not yet prevalent and does not view ESG disclosure as a pertinent matter that can affect stakeholders' decisions explains why disclosure has not had a significant impact on the cost of debt (Eliwa et al. 2021). The success of this process depends on the ability of market participants to appropriately incorporate this non-financial disclosure information about firms into their risk analysis decision-making. In this regard, the financial market must be familiar with and understand the ESG nomenclature and its interpretation.

The country's priority, which serves as the research context, must also be determined by its characteristics. As an emerging market, Indonesia has distinct priorities from developed countries. ESG practices are regarded as a social phenomenon that results from the activities and interactions of agents within a complex array of influences, including external economic forces, related ideologies, national economic conditions, and law established by governments (Ahmed et al. 2018). Considering these circumstances, Maaloul et al. (2023) have argued that there is no direct relationship between ESG disclosure and the cost of debt. Nonetheless, firms that manage and disclose ESG information to the greatest extent will have a better reputation than those that do so minimally. Therefore, ESG disclosure may affect the cost of debt if there is a mediating variable. These findings confirm the stakeholder theory, which holds that all stakeholders have a right to receive information about how organizational activities affect them, even when they decide not to use it and are unable to directly contribute to the organization's existence. The evidence specifically demonstrates that the influence of ESG practices on the cost of debt is more pronounced in stakeholder-oriented countries, where community engagement is more significant.

Moderating effect of political connections on the relationship between real earnings management and cost of debt

The study results indicate that political connections do not weaken the positive relationship between real earnings management and the cost of debt. This finding is in line with a study by Bliss et al. (2018), who noted that creditors charge higher interest rates to politically connected firms because of their heightened risk perceptions, particularly when such firms simultaneously engage in REM. This assertion is corroborated by Krammer and Jiménez (2020), who stated that when firms struggle to obtain political resources, they incur high rent-seeking costs and excessive compensation for executives. The aforementioned expenditure may deplete R&D capital for enterprises. Even if the desired resources are obtained, firms may be vulnerable to potentially distorting their typical investment and innovation pathways (Dang & So, 2018). Furthermore, political connections can facilitate businesses in circumventing government oversight and increasing executives' incentives related to earnings management and overinvestment. This may also reduce market competitiveness and R&D intensity, ultimately undermining the long-term profitability of the firm. For politically connected firms that simultaneously employ real earnings management, creditors consider the weakening of their competitive advantage and long-term profitability as acting against stakeholders' interests, thereby increasing the risk associated with these firms. Ultimately, this will increase the cost of debt demanded by creditors.

Moderating effect of political connections on the relationship between ESG disclosure and cost of debt

The results of this study reveal that political connections strengthen the negative relationship between ESG disclosure and the cost of debt. According to the stakeholder theory, creditors respond to politically connected firms that disclose their ESG practices by aligning their activities with stakeholders' interests. This study shows that ESG disclosure alone does not significantly impact the cost of debt. The relationship between ESG disclosure and the cost of debt becomes significant when political connections are taken into account as a moderating factor. This indicates that the influence of ESG disclosure on debt costs is dependent on the firm's political connections.

When politically connected firms are transparent about their ESG disclosure, creditors' concerns about potential concealed risks or unethical behavior can be alleviated. ESG disclosure can strengthen the firm's credibility by acting as an additional signal of good governance and enhanced monitoring. As a result, the relationship between ESG disclosure and the cost of debt is more pronounced in the presence of political connections, as these connections further enhance the creditors' perception of the firm's stability and reliability, assuming that the board members are prominent and have a good reputation. This can bolster public political confidence, as the public may believe that the firm is well governed by a board with political connections, thereby improving its reputation (Fanani & Alfiyanti, 2020).

CONCLUSIONS

This study examines the relationship between real earnings management, ESG disclosure, and the cost of debt among non-financial listed firms in Indonesia, while also considering the moderating effect of political connections. The results reveal that real earnings management has a significantly positive relationship with the cost of debt. This indicates that capital market investors factor the detrimental effects of real earnings management on earnings quality and business risk into their calculated rate of return or cost of debt. In the context of the stakeholder theory, real earnings management raises ethical concerns because it can damage trust and relationships among organizations' stakeholders. Furthermore, the findings of this study show that ESG disclosure does not exhibit a significantly negative relationship with the cost of debt. This signifies that stakeholders—specifically creditors, lending institutions, and banks—have not reacted to firms' ESG disclosures by decreasing the cost of debt. The capacity of market participants to accurately integrate disclosure of non-financial information into their risk analysis and decision-making is essential for the efficacy of this process. In this regard, the financial market must comprehend and interpret ESG nomenclature and its interpretation.

This study also indicates that political connections do not weaken the positive relationship between real earnings management and the cost of debt. This is because creditors perceive politically connected firms as having greater risks, particularly when these firms simultaneously engage in real earnings management. Conversely, this study reveals that political connections strengthen the negative relationship between ESG disclosure and the cost of debt. When politically connected firms are transparent about their ESG practices, investors' and creditors' concerns about potential concealed risks or unethical behavior can be alleviated. This transparency in ESG disclosures can reduce credit risk perceptions for these firms, thereby reducing the cost of debt.

The findings of this study suggest that aligning financial and sustainability practices can provide various benefits to managers, including improved financial performance, enhanced investor confidence, and reduced business financing costs. The study results have implications and recommendations for policymakers and regulators. Although ESG disclosure may not directly impact the cost of debt, policymakers can encourage businesses to adopt standardized and rigorous ESG reporting practices. Meanwhile, regulators can improve the accessibility and comparability of ESG data by establishing explicit standards and incentives for ESG disclosure. This will help investors and creditors make better-informed decisions about a firm's sustainability and risk.

Despite its valuable implications, this study has several limitations that should be acknowledged. First, this study has limited capacity to evaluate the influence of the COVID-19 pandemic on the model. Second, this study also has another constraint in assessing the time lag elements that affect the cost of debt. In this regard, the exact number of years a specific factor should be delayed remains unknown.

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