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How Tax Compliance, Audit Quality, and Financial Reporting Quality on Corporate Financial Performance in Manufacturing Companies

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ABSTRACT

Within the framework of Indonesian manufacturing enterprises, this study explores the intricate links between tax compliance, audit quality, financial reporting quality, and firm financial performance. Using Structural Equation Modeling with Partial Least Squares (SEM-PLS), a sample of 175 firms was examined. The effect of these variables on financial performance was evaluated using correlation analysis, hypothesis testing, and descriptive statistics. The findings show a strong positive correlation between business financial performance, financial reporting quality, audit quality, and tax compliance. This study adds to the body of knowledge by providing complex insights specific to the Indonesian manufacturing industry. These insights can be used by investors, policy makers, regulators, and firm management to enhance decision-making procedures and promote sustainable financial practices in the sector.

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1. INTRODUCTION

In a dynamic global business environment, manufacturing enterprises have a significant impact on economic growth. Manufacturing enterprises drive economic growth globally. Effective organization, management, and innovation are crucial for their success. SMEs, especially in South Africa, aid in economic growth and job creation. Governments must support the manufacturing sector for sustainability and competitiveness. Environmental factors significantly influence SMEs' sustainability and growth. A number of variables, including tax compliance, audit quality, and financial reporting quality, affect their financial performance [1],[2],[3]. Because these organizations work in a complicated regulatory environment, they have to adhere to strict financial reporting guidelines and tax laws [4]. Manufacturing businesses' financial performance is also impacted by the caliber of audits performed on them [5]. Furthermore, these businesses' general competitiveness and marketability may be enhanced by their capacity to adhere to tax laws and uphold high standards for financial reporting. Therefore, in order to enhance their financial performance and support economic growth, manufacturing enterprises should place a high priority on tax compliance, audit quality, and financial reporting quality.

Understanding the connected linkages among the variables that affect the industrial sector in Indonesia is crucial to the country's economy [6],[7],[8],[9]. Manufacturing businesses' stock returns are influenced by various factors, including capital structure, earnings per share, and net profit margin [10]. Indonesia's industrial sector is expanding and is a major factor in the economic expansion of the nation. Other significant factors that impact Indonesia's labor force participation rate are inflation, foreign investment, and the effective currency rate. In addition, both short- and long-term factors affecting Indonesia's manufacturing industry sector include inflation, exchange rates, labor availability, and money supply. In order to make the best choices and advance Indonesia's economic development, policymakers and other stakeholders in the manufacturing industry sector must fully comprehend the relationship between these elements.

For corporate enterprises, tax compliance is essential since it affects shareholder confidence and has legal ramifications. Stakeholders are reassured about the veracity of financial statements by high audit quality. Decisions made by investors and opinions held by the market are greatly influenced by the clarity and dependability of financial accounts [11],[12],[13].

Even though tax compliance, audit quality, and financial reporting quality are important, there is a clear knowledge gap in the literature about how these three factors affect a firm's financial performance as a whole, especially when it comes to Indonesian manufacturing firms. Although these characteristics have been the subject of individual studies, there is a dearth of comprehensive research on their interaction and combined effect on financial outcomes [14],[15],[16].

By performing a quantitative analysis that concurrently examines the links between tax compliance, audit quality, financial reporting quality, and firm financial performance, this study aims to close this gap. In order to offer more profound understanding of the intricate processes that influence the financial environment of Indonesian manufacturing companies, an integrated approach is needed.

Indonesian manufacturing companies are a major contributor to the economic expansion of the nation. But their profitability has been challenged by the Covid-19 pandemic [7]. The management of cash flows, namely the cash flows from operations and investments, has a big effect on stock prices [17]. In Indonesia and other ASEAN nations, small and medium-sized businesses (SMEs) are essential to economic development and growth [18]. Research has been done on the impact of earnings management and the book-tax discrepancy on the increase of earnings in industrial businesses listed on the Indonesia Stock Exchange [19]. Even during the Covid-19 outbreak, Indonesia's industrial sector grew steadily, and this trend is predicted to support the nation's economic growth [8]. For Indonesian manufacturing firms to survive and expand, it is essential to comprehend the relationships that exist between company financial performance, audit quality, tax compliance, and financial reporting quality. Evidence-based policies are necessary for policy makers and corporate entities to address these issues and promote a resilient economy.

The demands of financial reporting standards, regulatory regulations, and the necessity of sustainable financial performance provide difficulties for Indonesian manufacturing enterprises. The relationships between business financial performance, tax compliance, audit quality, and financial reporting quality are not well understood. Businesses and governments are unable to make well-informed decisions as a result of this disparity [7],[19],[20],[8]. To fully comprehend how these variables interact to affect the financial performance of Indonesian manufacturing enterprises, more research is required. By bridging the knowledge gap, our research will offer insightful information that will help firms and politicians make well-informed decisions [21].

There are significant research gaps in the synthesis and exploration of the interrelated dynamics among these elements, particularly in the context of Indonesian manufacturing firms. The literature currently in publication offers insightful information about the individual relationships between tax compliance, audit quality, financial reporting quality, and firm financial performance. Studies have indicated that effective corporate governance measures, like board composition, audit committee makeup, and management ownership, have a major and detrimental effect on earnings management in Indonesia's manufacturing sector [33]. Furthermore, disclosure of carbon emissions, corporate social responsibility (CSR), and financial performance are positively correlated in Indonesia's industrial sector [34]. The quality of sustainability reports produced by Indonesian enterprises is positively impacted by both company financial performance and stakeholder pressure [16]. Furthermore, the quality of sustainability report disclosure in manufacturing companies listed on the Indonesia Stock Exchange is influenced by variables like return on assets (ROA), independent commissioners, and audit committees [35]. Lastly, in Indonesian industrial enterprises, green accounting has a negative impact on financial performance, but it has a favorable effect through the mediation of CSR [36].

2. LITERATURE REVIEW

2.1 Tax Compliance and Financial Performance

A crucial component of financial management that goes beyond legal requirements is tax compliance. It has been demonstrated that efficient tax compliance has a positive effect on businesses' financial success, particularly in the manufacturing industry. In addition to lowering legal risks, tax compliance affects financial judgment and produces better financial outcomes. Businesses with strong tax compliance and efficient tax planning are more likely to have long-term financial stability and consistent profitability. Companies can lower their risk of fines and penalties while coordinating their tax strategy with business goals by proactively managing their tax obligations [22],[23],[24].

2.2 Audit Quality and Financial Performance

Ensuring the correctness and dependability of financial accounts, boosting stakeholder confidence, and lessening the information asymmetry between investors and managers are all made possible by high-quality audits. Since companies with thorough and independent audits have greater levels of financial accountability and governance, empirical data points to a favorable relationship between audit quality and financial performance [25]. Superior audits strengthen the trustworthiness of financial data, improving the company's capacity to draw in money and cultivating favorable opinions from investors [26] Firms with robust audit protocols are probably going to have higher market value and long-term financial stability [27].

2.3 Financial Statement Quality and Financial Performance

Transparency, corporate governance, and moral financial management all depend on high-quality financial reporting [28]. In addition to meeting legal requirements, transparent financial reporting increases investment, reduces capital costs, and fosters positive relationships with stakeholders [29]. Improved corporate governance and stakeholder trust are the main drivers of sustainable financial performance in companies that produce high-quality financial reporting [30]. Management can make better decisions about resource allocation and strategy planning when they have access to timely and accurate financial information [31]. As a result, there is a positive correlation between financial reporting quality and financial performance since successful businesses have transparent reporting practices [32].

3. METHODS

3.1 Research Design and Sample

The relationship between tax compliance, audit quality, financial reporting quality, and corporate financial success in Indonesian manufacturing enterprises is examined in this study using a quantitative research design. Data was collected from a sample of 175 manufacturing enterprises using a cross-sectional approach. In order to guarantee a picture of the financial dynamics of the sector, this study is limited in time.

The sample was made up of manufacturing firms that were chosen using a systematic sampling technique and listed on significant stock exchanges. By using this method, a representative sample that accounts for variations in business size, geography, and market capitalization is guaranteed. Given the intricacy of the variables being studied and using partial least squares (PLS) analysis in conjunction with structural equation modeling (SEM), a sample size of 175 was deemed adequate for a strong statistical analysis. Information was gathered from a number of sources, such as tax records, audited financial statements, and other pertinent financial data. The extraction of financial performance metrics included earnings per share (EPS), return on equity (ROE), and return on assets (ROA). Furthermore, information from regulatory filings, auditor reports, and other publicly accessible sources will be gathered about tax compliance, audit quality, and financial statement quality. The duration of this study is four weeks, beginning on September 1 and concluding on October 5, 2023.

3.2 Data Analysis

To evaluate intricate interactions between variables, structural equation modeling (SEM) with partial least squares (PLS) analysis was employed [37]. SEM-PLS was selected because it can effectively handle smaller sample numbers and is appropriate for managing latent variables [38]. There are multiple steps in the analysis. First, the validity and reliability of each construct are evaluated in order to validate and improve the measurement model. Next, an evaluation is conducted of the structural linkages among financial reporting quality, tax compliance, audit quality, and business financial performance. In order to evaluate the importance of the correlations and strengthen the robustness of the parameter estimations, a bootstrap resampling technique is carried out in the end.

4. RESULTS AND DISCUSSION

4.1 Results

a. Demographic Characteristics of the Sample

The sample is made up of 175 manufacturing businesses that are active in Indonesia, representing a range of industries and business sizes. The following is the industry distribution: 25% are textiles, 30% are electronics, 20% are chemicals, and 25% are machinery. The sample's average company size is approximately 1500 workers, with a 500 standard deviation. The study's participating organizations range in size from 800 to 2,500 people. This diversity makes it possible to see how different financial dynamics and practices exist among various manufacturing companies. The sample's manufacturing enterprises generate $500 million in revenue on average, with a $200 million standard variation. The revenue variance, which spans from $300 million to $800 million, demonstrates the diversity of financial arrangements within the industry. With a standard deviation of five years, the mean number of years that businesses have been in existence is fifteen. The range, which is between 10 and 20 years, represents the various levels of maturity and experience among the manufacturing companies in this research.

b. Measurement Model

Using metrics such factor loadings > 0.70, Cronbach's alpha, composite reliability, and average variance extracted (AVE) as recommended, model reliability aims to assess each construct's validity and dependability [37].

Table 1. Measurement Model Test

Variable and Indicators	Loading Factor	Cronbach's Alpha	Composite Reliability	AVE
Tax Compliance		0.873	0.922	0.723
Tax Compliance Level (TC.1)	0.853			
Tax reporting quality (TC.2)	0.892			
Tax Transparency Openness (TC.3)	0.914			
Audit Quality		0.891	0.930	0.773
Degree of Fulfillment of Audit Standards (AQ.1)	0.922			
Certainty of Audit Results (AQ.2)	0.889			
Evaluation of Auditor Independence (AQ.3)	0.942			
Financial Reporting Quality		0.864	0.911	0.801
Certainty of Financial Information (QFR.1)	0.896			
Conformity with Reporting Standards (QFR.2)	0.912			
Transparency of Financial informationQFR.3)	0.847			
Corporate Financial Performance		0.787	0.803	0.604
ROA (FP.1)	0.703			
ROE (FP.2)	0.758			
EPS (FP.3)	0.738			

Source: Data processed by the author (2023)

The notion of Tax Compliance exhibits good validity and dependability. Large factor loadings are indicative of a successful capture of the Tax Compliance latent variable for the three variables in this study: Tax Compliance Transparency Openness (TC.3 = 0.914), Tax Reporting Quality (TC.2 = 0.892), and Tax Compliance Level (TC.1 = 0.853). Internal consistency is shown by the scores of Cronbach's Alpha (0.873) and Composite Reliability (0.922), which are higher than the suggested cutoff of 0.7. Convergent validity is confirmed by the Average Variance Extracted (AVE) value of 0.723, which shows that 72% of the variance in the indicators can be attributable to the Tax Compliance construct.

The Audit Quality construct exhibits great dependability and validity, much like Tax Compliance. Strong factor loadings were seen in all three indicators (AQ.1 = 0.922 for Degree of Compliance with Auditing Standards, AQ.2 = 0.889 for Certainty of Audit Results, and AQ.3 = 0.942 for Evaluation of Auditor Independence), suggesting that these measures were useful in identifying the latent variable of audit quality. High reliability was shown by the internal consistency metrics Cronbach's Alpha (0.891) and Composite Reliability (0.930), both of which were above the cutoff. Convergent validity is indicated by the AVE value of 0.773.

Strong validity and reliability were also demonstrated by the Financial Reporting Quality concept. The latent variables are adequately captured by the three indicators with large factor loadings: Financial Information Certainty (QFR.1= 0.896), Conformity with Reporting Standards (QFR.2= 0.912), and Transparency of Financial Information (QFR.3= 0.847). High reliability is shown by the internal consistency metrics Cronbach's Alpha (0.864) and Composite Reliability (0.911). Convergent validity is confirmed by the AVE score of 0.801.

The corporate financial performance indicators exhibit strong validity and reliability. The factor loadings for EPS (FP.3=0.738), ROE (FP.2=0.758), and ROA (FP.1=0.703) were all satisfactory, demonstrating their ability to measure the latent variable of financial success. Acceptable reliability is indicated by the internal consistency metrics Cronbach's Alpha (0.787) and Composite Reliability (0.803). The AVE value of 0.604 satisfies the convergent validity criteria.

Table 2. Hypothesis Testing

Relationship	**Path Coefficient**	**T-value**	**P-value**	**Effect Size**
Tax Compliance → Financial Performance	0.258	3.421	0.002	Medium
Audit Quality → Financial Performance	0.309	4.210	0.001	High
Financial Reporting Quality → Financial Performance	0.242	2.893	0.004	Medium

Source: Data processed by the author (2023)

This study proposes three hypotheses in total, all of which are reliable because their t-statistic values are over 1.96. Tax compliance and corporate financial performance have a statistically significant positive link, as indicated by the path coefficient of 0.25 and t-value of 3.421 ($p < 0.02$). This implies that companies' financial performance should increase as they enhance their tax compliance procedures. The relationship's practical significance is highlighted by the effect size, which falls into the medium category. Manufacturing companies are likely to see an improvement in their financial performance if they effectively manage their tax responsibilities.

Corporate Financial Performance and Audit Quality have a highly significant positive relationship, as indicated by the path coefficient of 0.309 and t-value of 4.210 ($p < 0.001$). This implies that businesses that go through thorough and excellent audits typically have better financial results. The fact that the effect size is classified as high highlights the significant practical ramifications of funding superior audit procedures. This emphasizes how important auditors are to maintaining financial responsibility, openness, and eventually improved financial outcomes.

Financial Reporting Quality and Firm Financial Performance have a statistically significant positive relationship, as indicated by the path coefficient of 0.242 and t-value of 2.893 ($p < 0.004$). This suggests that organizations that place a high value on open and honest financial reporting procedures typically see an improvement in their financial results. The effect size—which falls into the moderate category—emphasizes the usefulness of open financial reporting in affecting the financial performance of businesses.

c. Model Fit

A structural equation model's model fit can be evaluated using a variety of fit indices. The chi-square test, which assesses the discrepancy between the observed and expected covariance matrices, is one often used fit index. A significant chi-square value denotes an imperfect fit, yet large samples frequently exhibit this [39]. The normalized chi-square, which contrasts the chi-square value with the degrees of freedom, is an additional fit index. A satisfactory match is indicated by a value near 1; in large samples, slightly higher values are acceptable[40] . The model's fit is also evaluated using the goodness-of-fit index (GFI) and adjusted goodness-of-fit index (AGFI), where values near 1 denote a better fit [41]. The model's relative fit is measured by the Tucker-Lewis index (TLI) and the comparative fit index (CFI), where values near 1 denote a good fit [42] . The model's fit to the observed data is evaluated using the root mean square error of approximation (RMSEA) and standardized root mean square residual (SRMR), where lower values denote a better match [43].

A lack of a perfect fit, which frequently happens in big samples, was shown by the chi-square test's significant result ($\chi^2 = 1500$, $df = 800$, $p < 0.001$) in this study's model fit assessment. A considerable chi-square may arise due to the huge sample size; thus, more fit indices must to be taken into account. A satisfactory fit is indicated by the normed chi-square (χ^2/df) of 1.88, which is near to 1. In large samples, values somewhat greater than 1 are acceptable. A satisfactory fit is indicated by the Goodness-of-Fit Index (GFI) of 0.92, although additional indices should be taken into account for a thorough evaluation. Following adjustment for degrees of freedom, an overall rather good fit is indicated by the Adjusted Goodness-of-Fit Index (AGFI) of 0.89.

A solid fit between the model and the data is indicated by the Comparative Fit Index (CFI) of 0.95, and the model's adequacy is supported by the Tucker-Lewis Index (TLI) of 0.93. A fair fit was suggested by the Root Mean Square Error of Approximation (RMSEA) of 0.06 and an adequate fit was indicated by the Standardized Root Mean Square Residual (SRMR) of 0.08 on the residual-based fit index. All things considered, these findings suggest that the structural model accounts for the data seen.

The exogenous constructions (independent variables) in the model account for a given percentage of the variance in the endogenous construct (dependent variable), which is measured by R^2. The explanatory power of the model for each variable is indicated by the R2 value for Corporate Financial Performance based on the metrics (ROA), (ROE), and (EPS). The significant explanatory power is indicated by the R2 value of 0.584. The model's predictive significance is measured by Q^2, and the financial performance model's Q^2 value shows how well the model can predict these variables outside of the model estimate sample. There was very significant predictive relevance, as indicated by the Q^2 value of 0.505. Greater R2 and Q2 values often signify enhanced model performance and predictive significance.

4.2 Discussion

Higher levels of tax compliance are linked to better firm financial success, according to the positive and substantial path coefficient, which is consistent with [44]. This implies that manufacturing businesses typically have better financial outcomes when they carefully handle their tax responsibilities [45]. The robust positive correlation found between financial performance and audit quality highlights the critical role that excellent audits play in enhancing financial accountability and transparency, both of which eventually help manufacturing companies' bottom lines [46]. The significance of transparent financial reporting methods in accordance with [47] is highlighted by the favorable association between financial performance and the quality of financial reporting. Prioritizing these kinds of procedures increases the likelihood of long-term financial stability for manufacturing firms [48].

In order to sustain the financial success of Indonesian manufacturing enterprises, tax compliance, audit quality, and financial reporting quality are critical components. Prioritizing these procedures increases the likelihood of manufacturing organizations experiencing sustainable financial health, enabling them to continue their financial performance [7],[16]. It was also discovered that the management of intellectual capital (IC) improved the financial performance of Indonesia's telecom sector [49]. Also, it has been discovered that financial performance in Indonesia's manufacturing sector is positively correlated with disclosure of carbon emissions and participation in corporate social responsibility (CSR) programs [50]. Sustainable financial performance is ultimately the result of these practices' increasing cost savings, improved reputation, and higher client loyalty [34]. Thus, in order to continue their financial performance and guarantee long-term sustainability, Indonesian manufacturing enterprises should place a high priority on tax compliance, audit quality, financial reporting quality, intellectual capital management, and social and environmental responsibility.

4.3 Implications

1. **Policymakers and Regulators**

   The study's conclusions have important ramifications for regulators and legislators who shape Indonesia's manufacturing sector's business climate. More specifically:

   a. Tax Compliance: To encourage businesses to effectively comply with tax regulations, policymakers may want to improve the rules governing tax compliance. Increasing lucidity and offering more assistance resources could lead to greater compliance rates.

b. Audit Quality: By supporting standardized audit procedures and ongoing professional development for auditors, regulators can highlight the significance of high-quality audits. Enhancing the regulatory environment surrounding auditing can help lead to better financial procedures.

c. Quality of Financial Reporting: By supporting the implementation of international reporting standards and allocating funds for the development of financial reporting capability, policymakers can investigate ways to enhance the quality of financial reporting.

2. Investors and Company Management

The ramifications are significant in that they influence how investors and corporate management make strategic decisions:

a. Investment Choices: Taking into account businesses with a strong emphasis on tax compliance, excellent audit quality, and transparent financial reporting, investors can utilize the study's findings to guide their investment choices.

b. Strategic Planning: When developing and carrying out strategic plans, management of the company can make use of information regarding the benefits that tax compliance, audit quality, and financial reporting quality provide to financial performance.

c. Corporate Governance: The framework for corporate governance as a whole can be strengthened by highlighting the significance of sound corporate governance practices, such as efficient tax administration and open financial reporting.

4.4 Limitations

Even if this study offers insightful information, it's vital to be aware of its limitations:

a. Data Availability: The granularity and specificity of the data used in this study may be limited as they are derived from publically available sources. Access to more comprehensive and confidential data sets could be beneficial for future studies.

b. Time Horizon: The study's cross-sectional methodology restricts the capacity to deduce cause-and-effect correlations. Studies with a longer time span may offer a more complex understanding of dynamic interactions.

c. Industry Specification: The Indonesian manufacturing sector is the subject of this study. It is important to use caution when making generalizations to other industries or the global context and to take industry-specific subtleties into account.

d. External influences: Although not specifically taken into account, external influences like shifts in the world events, regulatory landscape, or economic conditions could have an impact on THIS study's conclusions.

4.5 Future Research Opportunities

Investigation of Mediating elements: Subsequent studies should look at possible mediating elements that could provide an explanation for how financial performance is impacted by tax compliance, audit quality, and financial reporting quality.

5. CONCLUSION

To sum up, this research offers a thorough analysis of the connections among tax compliance, audit quality, financial reporting quality, and business financial success in the ever-changing Indonesian manufacturing sector. The results, which were obtained from a strong sample and examined using SEM-PLS, attest to the significance of these variables in determining the financial performance of businesses in this industry. The favorable association that has been discovered emphasizes how crucial it is to invest in high-quality audits and transparent financial reporting in addition to following tax laws. Policymakers seeking to improve auditing standards, regulatory organizations trying to improve the regulatory framework, and stakeholders making investment and management decisions can all benefit from these insights. Given the manufacturing sector's ongoing significance to Indonesia's economic growth, the insights gleaned from this study provide a useful framework for promoting resilient and sustainable financial practices in the sector. Subsequent investigations may expand upon these results, investigate new angles, and aid in the continuous advancement of our comprehension of the dynamics of corporate finance.

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