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Financial Reporting Quality as a Mediating Mechanism Between Internal Control, Operational Efficiency, and Financial Performance of MSMEs

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Abstract

This study investigates how Internal Control and Operational Efficiency contribute to the financial performance of micro, small, and medium enterprises (MSMEs) in the food and beverage sector in West Semarang District, with Financial Reporting Quality serving as a mediating variable. A quantitative research design was employed, and the data were analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM) with SmartPLS 4. The findings reveal that both Internal Control and Operational Efficiency significantly and positively influence Financial Reporting Quality. In addition, Operational Efficiency and Financial Reporting Quality exert positive and statistically significant effects on Financial Performance. However, Internal Control does not demonstrate a statistically significant direct relationship with Financial Performance. The mediation analysis further indicates that Financial Reporting Quality mediates the relationships of both Internal Control and Operational Efficiency with Financial Performance. These results underscore the importance of reliable financial reporting in translating internal control practices and operational efficiency into improved financial outcomes for food and beverage MSMEs.

Keywords:
Internal control; Operational efficiency; Financial reporting quality; Financial performance; MSMEs.

1. INTRODUCTION

Micro, Small, and Medium Enterprises (MSMEs) play a significant role in driving economic activities. Their internal organizational characteristics are closely associated with the quality of financial reporting, while effective internal control serves as an essential mechanism for supporting business performance (Rubiyatno & Theodorus, 2024; To Tam & Tuan, 2021). However, further investigation is needed to gain a more comprehensive understanding of how internal organizational factors, financial reporting quality, and financial performance are interconnected (Asmira, 2025; Supriyati & Suharman, 2026). An integrated examination of these relationships is important because the effectiveness of internal management practices may depend not only on how business activities are controlled and resources are utilized, but also on how financial information is recorded, presented, and used in managerial decision-making. This study therefore examines the direct and indirect relationships among these variables, with Financial Reporting Quality (FRQ) positioned as a potential mediating mechanism linking internal management practices to MSME financial performance.

Internal Control serves as a mechanism for guiding business operations, mitigating potential risks, and ensuring the credibility of financial information. Its implementation is particularly relevant for MSMEs, where resource constraints and the inadequate segregation of duties may hinder effective oversight. Previous research indicates that the effectiveness of internal control systems is associated with the quality of financial reporting among MSMEs (Hermanto, Kalbuadi, Farha, & Ibrahim, 2022; Maia & Gusmao, 2026). From an internal governance perspective, effective internal control can support more systematic transaction recording, improve the consistency of accounting procedures, and reduce the likelihood of errors in financial information. These functions provide a theoretical basis for expecting internal control to improve FRQ. However, whether stronger

internal control also translates directly into better financial performance remains an empirical question, particularly in MSMEs where the benefits of control mechanisms may be realized through improvements in financial information and managerial decisions.

In addition to IC, Operational Efficiency (OE) is an important factor in MSME management. Efficient resource utilization can help reduce waste, control costs, and increase productivity. Rahmiyati, Wahidhani, & Fitrianingsih (2024) investigated how operational efficiency relates to the long-term financial viability of small enterprises., while (Arisandi, Islami, & Soeprajitno, 2022; Ramadani & Rosyidi, 2025) highlighted the relevance of process improvement and waste reduction to productivity. Operational efficiency may also contribute to FRQ because well-organized business processes can facilitate the timely recording of transactions, monitoring of operating costs, and preparation of financial information. At the same time, efficient operations may improve financial performance directly by reducing unnecessary expenditure and supporting the more productive use of available resources. These arguments suggest that OE may be associated with financial performance through both operational outcomes and the quality of financial information available for decision-making.

FRQ plays an important role in providing information that enables business owners to evaluate financial conditions and make informed decisions. Earlier research has explored the association between the quality of financial reporting and business performance, as well as the use of financial statement analysis as a basis for strategic decision-making among MSMEs (Auliyah & Agit, 2024; Nurdin & Pramanik, 2025). Financial reports that provide reliable, relevant, and understandable information can help business owners assess revenues, expenses, cash flows, and financial obligations more systematically. Such information can support decisions concerning cost management, resource allocation, and business development. Consequently, FRQ may serve as a mechanism through which internal control and operational efficiency contribute to financial performance. Nevertheless, the extent to which FRQ mediates these relationships requires empirical testing rather than being assumed from the theoretical arguments alone.

Recent international research has increasingly highlighted the role of digitalization in strengthening MSME financial management, financial reporting, and business performance. Gao et al. (2023) examined the adoption of e-commerce and digital marketing among MSMEs and reported that digital adoption was associated with financial and sustainability performance during the COVID-19 pandemic. Although their study focused on broader digital business practices rather than financial reporting alone, it illustrates how digital transformation can support business outcomes. Similarly, Komala & Firdaus (2023) investigated the relationship between the digital economy, financial statement quality, and MSME survival in Indonesia and Malaysia, finding that the digital economy was associated with improved financial statement quality. Kurnia et al. (2023) also discussed digitalization and digital financial inclusion as factors relevant to the development of informal MSMEs and their participation in the formal economy. These studies suggest that digital transformation can support MSME development, although its implications for the quality of financial information and business performance need to be examined in relation to internal management practices.

More recent studies have provided a closer examination of digital accounting and financial reporting quality. Asmira (2025), in their study of MSMEs in East Lombok, found that internal control had a positive and significant effect on financial reporting quality, whereas accounting digitalization did not demonstrate a statistically significant positive effect. This finding indicates that the adoption of digital tools alone may not be sufficient to ensure reliable financial reports. In contrast, Putri et al. (2025) found that cloud accounting adoption positively and significantly improved financial report quality among MSMEs in Central Java. Taken together, these findings indicate that digitalization can support financial reporting, but its effectiveness may depend on the organizational and control practices accompanying its implementation. However, the existing studies do not fully explain how internal control and operational efficiency relate to financial performance through financial reporting quality in food and beverage MSMEs. Addressing this issue, the present study examines financial reporting quality as a mediating variable linking internal control and operational efficiency with financial performance.

Although research on Internal Control, Operational Efficiency, Financial Reporting Quality, and Financial Performance has been conducted, there is still room to look at these relationships in an integrated manner (de la Puente, Torres, Guzman, Rico, & Navarro, 2026; Maryanti, Mediaty, Arifin, & Mas' ud, 2026). Previous research has examined more direct relationships between variables, so the mechanism of Financial Reporting Quality as a link between internal management and financial performance still needs to be clarified (Pratama, Kusumawardani, & Herlina, 2025; Sari & Anggraweni, 2024). In addition, differences in the characteristics of MSMEs and the business environment cause the results of previous research not necessarily to be generalized in all MSME contexts. This study addresses this gap by examining the direct effects of IC and OE on FP, their effects on FRQ, the effect of FRQ on FP, and the indirect effects of IC and OE on FP through FRQ. This integrated approach allows the mediating role of financial reporting quality to be evaluated alongside the direct relationships between internal management practices and financial performance.

The novelty of this study lies in the development of an integrated research model that examines the role of Financial Reporting Quality in mediating the relationship between Internal Control and Operational Efficiency and Financial Performance (Vu & Nga, 2022). Unlike previous studies that have primarily focused on direct relationships between these variables, this study simultaneously investigates their direct and indirect

effects to provide a more comprehensive understanding of the mechanisms underlying MSME financial performance (Jensen & Meckling, 2019; Safitri & Estiningrum, 2022). By examining food and beverage MSMEs in West Semarang District, this study provides context-specific evidence on whether internal control and operational efficiency are associated with financial performance directly, indirectly through FRQ, or through both pathways. The findings are expected to contribute to the literature on MSME management and provide practical insights into the role of internal management practices and financial reporting in supporting business performance.

Based on the research gap, this study aims to analyze the influence of Internal Control and Operational Efficiency on Financial Performance through Financial Reporting Quality as a mediating variable in food and beverage MSMEs in West Semarang District. This research is expected to contribute by explaining the direct and indirect relationship between variables in one model, especially the role of Financial Reporting Quality as a mechanism that connects internal management with the financial performance of MSMEs.

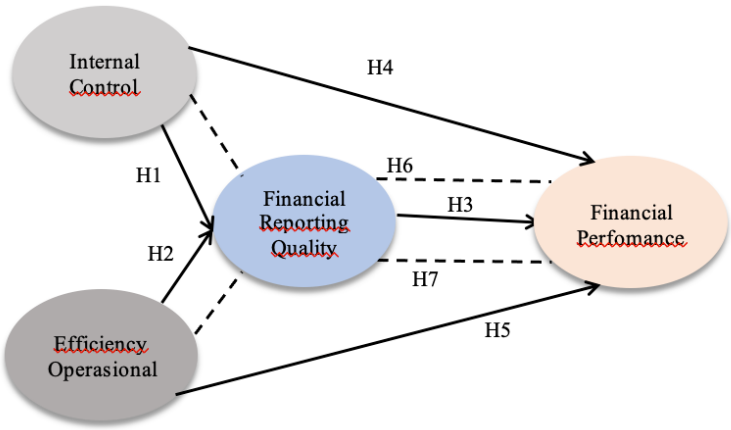


Figure 1. Research Conceptual Framework

Figure 1 depicts the proposed model linking Internal Control (IC), Operational Efficiency (OE), Financial Reporting Quality (FRQ), and Financial Performance (FP) in MSMEs through direct and indirect relationships. The model assumes that IC and OE contribute to FRQ by promoting effective control procedures and more efficient business operations, thereby supporting the production of reliable financial information. FRQ is also expected to improve FP by providing dependable information for financial assessment and managerial decision-making.

Furthermore, IC and OE are hypothesized to exert direct effects on FP through improved risk management, expenditure monitoring, resource allocation, and operational productivity. FRQ is incorporated as a mediating variable to examine whether IC and OE are indirectly associated with FP through improvements in financial reporting. Accordingly, the framework comprises seven hypotheses (H1–H7), covering five direct relationships and two indirect effects through FRQ. This integrated model provides a basis for examining how internal management practices and financial reporting quality relate to the financial performance of food and beverage MSMEs in West Semarang District, Indonesia.

2. RESEARCH METHOD

A quantitative explanatory design was adopted to investigate the relationships of Internal Control and Operational Efficiency with Financial Performance, while examining Financial Reporting Quality as a mediating variable among food and beverage MSMEs operating in West Semarang District, Indonesia. The research model comprised four variables: Internal Control (X1), Operational Efficiency (X2), Financial Reporting Quality (M), and Financial Performance (Y).

The target population comprised 145 food and beverage MSMEs in West Semarang District. A simple random sampling technique was applied, ensuring that each MSME in the population had an equal probability of selection. Respondents were randomly drawn from the population list, yielding a final sample of 100 participants. Eligible respondents were required to be at least 17 years old, have operated their businesses for at least two years, and maintain financial records as part of their business operations.

Data were obtained directly from the selected MSME respondents using a questionnaire survey. Prior to statistical analysis, the collected responses were reviewed to verify their completeness and determine their suitability for further processing. The data were then used to measure Internal Control (X1), Operational Efficiency (X2), Financial Reporting Quality (M), and Financial Performance (Y).

The collected data were analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM) in SmartPLS 4. The measurement model (outer model) was examined to establish the validity and reliability

of the measurement instruments, whereas the structural model (inner model) was assessed to evaluate the proposed relationships between the research constructs. These relationships covered the effects of Internal Control and Operational Efficiency on Financial Reporting Quality and Financial Performance, along with the effect of Financial Reporting Quality on Financial Performance.

Hypotheses were evaluated based on path coefficients, t-statistics, and p-values. The mediating function of Financial Reporting Quality was examined by analyzing the indirect effects of Internal Control and Operational Efficiency on Financial Performance through this construct. In total, seven hypothesized relationships were tested, consisting of five direct effects and two indirect effects involving Financial Reporting Quality as the mediator.

3. RESULTS AND DISCUSSION

The measurement model was assessed to determine whether the indicators adequately represented the research constructs in terms of validity and reliability. The results confirmed that all constructs satisfied the requirements for convergent validity. The Average Variance Extracted (AVE) values for Financial Performance, Financial Reporting Quality, Internal Control, and Operational Efficiency were 0.587, 0.555, 0.641, and 0.614, respectively. Since all values exceeded the minimum threshold of 0.50, the constructs demonstrated an adequate ability to account for the variance in their respective indicators.

Table 1. Measurement Model Evaluation Results

Construct	AVE	rho_A	rho_C
Financial Performance	0,587	0,826	0,876
Financial Reporting Quality	0,555	0,800	0,862
Internal Control	0,641	0,819	0,877
Operational Efficiency	0,614	0,856	0,888

Source: The researcher's data was processed using SmartPLS 4 (2026).

In addition to validity, the results of the reliability test showed that the entire construct had adequate internal consistency. The rho_A value was in the range of 0.800 to 0.856, while rho_C was in the range of 0.862 to 0.888. Thus, the research instrument was declared reliable and could be used for structural model testing.

3.1. Structural Model Evaluation

Structural model evaluation was carried out to determine the ability of variables in the research model to explain endogenous variables. The test results showed that the R-square value of Financial Reporting Quality was 0.515, while Financial Performance was 0.612.

Table 2. R-Square Test Results

Variable endogenous	R-square	R-square Adjusted
Financial Reporting Quality	0,515	0,505
Financial Performance	0,612	0,600

Source: The researcher's data was processed using SmartPLS 4 (2026).

The findings indicate that Internal Control and Operational Efficiency account for 51.5% of the variance in Financial Reporting Quality. Meanwhile, 61.2% of the variation in Financial Performance can be explained jointly by Internal Control, Operational Efficiency, and Financial Reporting Quality. These results suggest that the proposed model demonstrates a moderate level of explanatory power.

3.2. Hypothesis Testing

The hypotheses were evaluated through bootstrapping procedures in SmartPLS 4. The significance of direct relationships was determined by examining the Original Sample (O), T-statistic, and P-value. A relationship was considered statistically significant when the T-statistic exceeded 1.96 and the P-value was below 0.05.

Table 3. Hypothesis Test Results

Hypothesis	Relationship	O	T-statistic	P-value	Decision
H1	Internal Control → Financial Reporting Quality	0,394	3,043	0,002	Accepted
H2	Operational Efficiency → Financial Reporting Quality	0,403	3,173	0,002	Accepted

H3	Financial Reporting Quality → Financial Performance	0,411	4,099	0,000	Accepted
H4	Internal Control → Financial Performance	0,167	1,610	0,108	Rejected
H5	Operational Efficiency → Financial Performance	0,310	2,794	0,005	Accepted
H6	Internal Control → Financial Reporting Quality → Financial Performance	0,162	2,213	0,027	Accepted
H7	Operational Efficiency → Financial Reporting Quality → Financial Performance	0,166	2,635	0,008	Accepted

Source: The researcher's data was processed using SmartPLS 4 (2026).

Table 3 indicates that six hypotheses (H1, H2, H3, H5, H6, and H7) were supported, whereas H4 was not supported. The findings demonstrate that both Internal Control and Operational Efficiency positively and significantly affect Financial Reporting Quality. In addition, Operational Efficiency and Financial Reporting Quality exhibit positive and statistically significant relationships with Financial Performance. By contrast, the direct effect of Internal Control on Financial Performance is not statistically significant.

3.3. The Effect of Internal Control on Financial Reporting Quality

The hypothesis testing results indicate that Internal Control positively and significantly influences Financial Reporting Quality (β = 0.394, T-statistic = 3.043, P-value = 0.002). Therefore, H1 was supported. The findings suggest that stronger internal control practices are associated with better financial reporting among MSMEs.

Effective internal control helps maintain accurate transaction records, minimize the possibility of inaccurate financial information, and ensure the availability of dependable financial data. Accordingly, the implementation of appropriate control procedures represents an important factor in enhancing the quality of financial reporting in MSMEs.

3.4. The Effect Operational Efficiency of Financial Reporting Quality

Operational Efficiency demonstrates a positive and statistically significant influence on Financial Reporting Quality. The value of β = 0.403, T-statistic = 3.173, and P-value = 0.002 indicates that H2 is accepted.

These findings show that the ability of MSMEs to efficiently manage operational activities contributes to improving the quality of financial information. Efficiency in cost management, resource utilization, inventory control, and business processes can produce more structured operational data to support the preparation of financial statements. Thus, efficient management of operational activities is not only related to business processes, but also supports the availability of better financial information.

3.5. The Effect of Financial Reporting Quality on Financial Performance

The analysis indicates that Financial Reporting Quality contributes positively and significantly to Financial Performance. The value of β = 0.411, T-statistic = 4.099, and P-value = 0.000 indicates that H3 is acceptable.

The findings indicate that higher-quality financial reporting among MSMEs, the higher the Financial Performance that can be achieved. Quality financial information helps business owners understand business conditions, evaluate performance, control costs, and support business decision-making. Thus, Financial Reporting Quality not only functions as an administrative record, but can also be a source of information in business management and development.

3.6. The Effect of Internal Control on Financial Performance

The hypothesis testing results indicate that Internal Control has a positive but statistically insignificant effect on Financial Performance (β = 0.167). The T-statistic of 1.610 falls below the critical threshold of 1.96, while the P-value of 0.108 exceeds the 0.05 significance level. Consequently, H4 was not supported.

This finding suggests that Internal Control does not have a statistically significant direct effect on the financial outcomes of MSMEs in the context of this study. Internal control primarily functions to ensure that business activities and financial transactions are conducted in an orderly manner, whereas its contribution to financial performance appears to be associated with Financial Reporting Quality.

The results further suggest that establishing internal control procedures alone may not be sufficient to generate immediate improvements in financial performance. Their potential benefits become more evident when monitoring and recording activities produce reliable financial information that supports business evaluation and managerial decision-making. This interpretation is consistent with the mediation analysis, which confirms that Financial Reporting Quality serves as an intermediary in the relationship between Internal Control and Financial Performance.

3.7. The Effect of Operational Efficiency on Financial Performance

Operational Efficiency has a positive and statistically significant effect on Financial Performance, as indicated by the coefficient (β = 0.310), T-statistic of 2.794, and P-value of 0.005. Accordingly, H5 was supported.

The findings indicate that greater operational efficiency is associated with improved financial outcomes among MSMEs. Optimizing resource allocation, minimizing operating expenses, and streamlining business processes can directly contribute to better financial performance.

Therefore, operational efficiency represents a key factor in strengthening the financial performance of MSMEs. By managing business operations effectively and utilizing available resources more productively, MSMEs can improve their capacity to achieve favorable financial results.

3.8. The Mediating Role of Financial Reporting Quality in the Relationship between Internal Control and Financial Performance

The mediation analysis revealed that Internal Control has a positive and statistically significant indirect effect on Financial Performance through Financial Reporting Quality (β = 0.162, T-statistic = 2.213, P-value = 0.027). Therefore, H6 was supported.

The findings indicate that the contribution of Internal Control to Financial Performance is transmitted through improvements in Financial Reporting Quality rather than through a statistically significant direct relationship. This result is particularly noteworthy because the direct effect of Internal Control on Financial Performance is insignificant, whereas its indirect effect through Financial Reporting Quality is statistically significant.

These findings position Financial Reporting Quality as an important link between internal control practices and the financial outcomes of MSMEs. Effective internal control can facilitate the production of more accurate and dependable financial information, enabling business owners to assess their financial position, monitor expenditures, and make better-informed managerial decisions.

3.9. The Role of Financial Reporting Quality in Mediating the Influence of Operational Efficiency on Financial Performance

The analysis confirmed that Operational Efficiency exerts a positive and statistically significant indirect effect on Financial Performance through Financial Reporting Quality (β = 0.166, T-statistic = 2.635, P-value = 0.008). Accordingly, H7 was supported.

The findings suggest that improvements in MSME operational efficiency are associated with better financial reporting, which can subsequently contribute to stronger financial performance. Well-organized business operations facilitate the recording and monitoring of costs, revenues, inventory, and resource utilization, thereby supporting the preparation of more reliable financial information.

These results establish Financial Reporting Quality as an important mediating factor in the relationship between Operational Efficiency and Financial Performance. Beyond its direct contribution to financial outcomes, operational efficiency can also generate indirect benefits by enhancing the quality of financial information available for business assessment and managerial decision-making.

3.10. Key Findings

The findings highlight the central role of Financial Reporting Quality within the proposed research model. Internal Control and Operational Efficiency contribute positively and significantly to Financial Reporting Quality, which subsequently enhances Financial Performance. The results also confirm that Financial Reporting Quality serves as a mediating mechanism through which Internal Control and Operational Efficiency affect Financial Performance.

The most notable result concerns the relationship between Internal Control and Financial Performance. Although the direct effect is not statistically significant (β = 0.167; p = 0.108), its indirect effect through Financial Reporting Quality is significant (β = 0.162; p = 0.027). This finding indicates that Financial Reporting Quality provides an important link between internal control practices and the financial outcomes of MSMEs. Accordingly, better financial performance depends not only on effective internal control and efficient business operations but also on the capacity of MSMEs to prepare high-quality financial reports that provide a reliable foundation for managerial decision-making.

4. CONCLUSION

This research investigates whether Financial Reporting Quality mediates the effects of Internal Control and Operational Efficiency on the financial outcomes of food and beverage MSMEs in West Semarang District, Indonesia. The findings demonstrate that Internal Control and Operational Efficiency are positively and significantly associated with Financial Reporting Quality. Furthermore, better Financial Reporting Quality contributes significantly to improved Financial Performance. These results emphasize the value of producing accurate and dependable financial reports to support the financial success of MSMEs.

The analysis also reveals that Operational Efficiency has a positive and statistically significant direct influence on Financial Performance. In contrast, the direct relationship between Internal Control and Financial Performance is not statistically significant. Financial Reporting Quality mediates the relationships of both Internal Control and Operational Efficiency with Financial Performance. The results indicate that Internal Control may influence Financial Performance indirectly by enhancing Financial Reporting Quality. Meanwhile, Operational Efficiency appears to contribute to Financial Performance through both a direct pathway and an indirect pathway involving Financial Reporting Quality.

Theoretically, this study contributes to the understanding of how Financial Reporting Quality functions as a mediating mechanism linking internal management practices to financial performance in the context of MSMEs. Practically, the findings suggest that MSME owners and managers should strengthen internal control procedures, improve the efficiency of resource utilization and operational activities, and maintain systematic financial records and reporting practices. These efforts can support more informed business decisions and the management of financial performance.

The findings suggest that Internal Control supports better Financial Performance primarily through its contribution to Financial Reporting Quality. In contrast, Operational Efficiency is linked to Financial Performance through both its direct impact and its indirect association mediated by Financial Reporting Quality.

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