

The Influence of Financial Distress, Leverage, Firm Size, And Profitability on Accounting Conservatism

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Abstract

Purpose: This study aims to examine and analyze the effect of financial distress, leverage, firm size, and profitability on accounting conservatism.

Methodology: The research sample this time is manufacturing companies listed on the Indonesian sharia stock index for 2017–2021. The method used in this study is panel data regression. This study uses the Fixed Effect Model as the best model in the study.

Findings: This test found that the variables financial distress and profitability have a significant positive effect on accounting conservatism. Meanwhile, leverage and firm size have no effect on accounting conservatism.

Novelty: This study continues previous research by using different samples and populations and adding an independent variable.

Keywords: Financial Distress, Leverage, Firm Size, Profitability, Accounting Conservatism

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Introduction

Statement of Financial Accounting Standards (PSAK) provides flexibility to companies in choosing accounting methods and estimates used in accordance with the needs adapted to the conditions of the company (Sulastri & Anna, 2018). The freedom given to management in the selection of accounting methods can affect management behavior. Management is more likely to report optimistic and overstated financial reports, overstatement that can mislead users of financial statements (Efendi & Handayani, 2021).

Accounting conservatism is the attitude in the face of uncertainty to take action or make a decision on the worst possibility that might arise from uncertainty (Septriana et al., 2021). Another definition explains that conservatism is a careful reaction to dealing with uncertainties that occur within the company that can ensure that uncertainty and risk in the corporate environment are enough to consider (Islami et al 2022). The application of this conservative principle is assessed as appropriate to use to be more careful in dealing with a situation that is uncertain and avoid excessive optimism from management and company owners (Dillak et al., 2017).

The application of the principle of conservatism is considered controversial because accounting conservatism is considered an obstacle that can affect the quality of financial reports, which tend to be biased or do not reflect actual reality (Easton & Pae, 2004). However, accounting conservatism is considered beneficial because it can avoid opportunistic management and prevent overly optimistic attitudes, which can result in over-reporting and a disparaging compilation report (Watts, 2003, Stephen, 2016).

The phenomenon related to the application of accounting conservatism is the mark-up case of what happened to PT KF financial statements. The re-audit found fault that the real net profit is equal to Rp.99,560,000,000 from the previous Rp.132,000,000,000, where Rp.32,600,000,000 is 24.7% lower than the initial reported profit. Presentation of overstatement due to several units at PT KF, namely the raw material industry unit, that reported overstated sales of Rp. 2,700,00,000, the central logistics unit reports inventory overstated at Rp. 23,900,000,000, the pharmaceutical wholesaler unit reports inventory overstated at Rp. 8,100,000,000, and sales overstated at IDR 10,700,000,000. The phenomenon at PT KF shows that the application of accounting conservatism principles has weaknesses that impact the overstatement of financial statements.

Accounting conservatism can be influenced by several factors, one of which is financial distress. Financial distress is a condition where a company experiences early symptoms of a decline in its capacity for finance (Sulastris & Anna, 2018). Financial difficulties occur when the company is unable to pay its short-term obligations (Debora et al., 2022). Short-term financial difficulties, but they could get worse in the future (Dillak et al., 2017). Fitriani & Ruchjana's reaserch (2020) shows that financial distress has a significant effect on accounting conservatism, while Pratidina & Majidah (2022) results show that financial distress does not have an influence on accounting conservatism.

Another factor that can affect accounting conservatism is leverage. Leverage used to see the extent to which the assets of the company are used and borne by debt (Priyono & Suhartini, 2022). Leverage can show how much the level of the company's ability to pay its obligations both short term and long term (Pratidina & Majidah, 2022). Research by Sulastris & Anna (2018) states that results leverage has a significant effect on accounting conservatism, whereas research conducted by Octavia (2022) showed such results not in line, namely leverage has no significant effect on accounting conservatism.

Another factor that influences accounting conservatism is firm size. The size of the company is the size where the size of the company is judged by the size of the assets owned by the company (Efendi & Handayani, 2021). Companies categorized as large companies are reflected in the company's profits so that it can trigger attention because there is a large political cost to the company (Octavia, 2022). Based on the perspective of positive accounting theory and political cost hypotheses, it is predicted that large companies will tend to apply the principle of accounting conservatism (Mousa, 2011) because it is more sensitive to aspects of political costs (Octavia, 2022). The application of accounting conservatism is necessary for companies to present smaller profits to avoid big political costs (Efendi & Handayani, 2021).

Profitability is one of the factors that can influence accounting conservatism, where profitability is the ratio used to assess the company's ability to earn profits during one period (Efendi & Handayani, 2021). Profitability describes effectiveness management carries out its operations (Abdurrahman & Ermawati, 2019) Study conducted by Solichah & Fachrurrozi (2020) states that there is a positive and significant effect of profitability on accounting conservatism, while Efendi & Handayani's research (2021) found results that profitability has no effect on accounting conservatism.

Literature Review

Positive accounting theory explains the application of abilities, understanding, and knowledge of accounting in determining policy-appropriate accounting for dealing with particular situations in the future (Watts & Zimmerman, 1990). This theory is used to predict phenomena and real events in the accounting world related to internal accounting practices and determine policies that can affect the company in the future (Waweru et al., 2011) According to Watts & Zimmerman (1990), there are three hypotheses in accounting theory that can drive a management decision to implement conservative principles or not.

Signal theory is a theory that involves two parties, namely internal and external. Internal parties, namely management, act as signaling parties, and external parties, namely investors, act as recipients of

signals (Spence, 1973). Signal theory describes the behavior of the two parties who have different access to information (Connelly et al., 2011).

Signaling theory explains the signaling from the agent to the principal with the aim of reducing the occurrence of information asymmetry (Spence, 1973). Agents provide information in the form of signals by increasing the application of accounting conservatism when the company is experiencing financial distress (Ross, 1977). Companies experiencing troubled financial conditions tend to prefer the principle of accounting conservatism to minimizing conflicts between investors and creditors. The company minimizes other expenses that can worsen the condition of financial costs, such as taxes borne by the company (Debora et al., 2022, Kao & Sie, 2016). So, companies that experience financial difficulties are compelled to be more conservative.

Research by Septriana et al. (2021) and Octavia (2022), which mentions that financial distress does not have a significant positive effect on accounting conservatism. Based on previous research and theory, the hypothesis in the study is as follows:

H1: Financial distress has a significant positive effect on accounting conservatism.

Based on the positive accounting theory of the corporate debt hypothesis, those with high levels of leverage are most likely to use accounting methods that can increase profits to improve the ratio of debt. Companies tend not to be conservative in preparing financial reports to maintain creditor confidence (Watts & Zimmerman, 1990).

A high leverage ratio carries a high financial risk, thereby encouraging management to use accounting methods that can increase profits to provide guarantees and minimize the termination of the debt contract by the creditor, but the reports presented tend to be optimistic and not conservative (Fitriani & Ruchjana, 2020).

This research is supported by previous studies, namely (Ahyaruddin et al., 2022), Fitriani & Ruchjana (2020), and Septriana et al. (2021), with results suggesting that leverage has a significant negative effect on accounting conservatism, while the opposite is found in the research of Solichah & Fachrurrozi (2020), Thomas & et al. (2020), and Octavia (2022) which states that leverage does not have a significant effect on accounting conservatism. Based on the theory and previous research, this research has a hypothesis as follows:

H2: Leverage has a significant negative effect on accounting conservatism.

Based on positive accounting theory, there is a political cost hypothesis: large companies will bear large political costs, so companies tend to defer current period profits to future periods (Efendi & Handayani 2021). A company that earns high profits can attract the attention of the government to increase political costs (Octavia, 2022). Companies are encouraged to apply the principle of conservatism in accounting when presenting their financial statements. The company presents lower profits by using a choice of accounting practices (Efendi & Handayani, 2021).

The company is getting bigger, and making a profit will be faced with huge political costs, so large companies tend to apply the principle of accounting conservatism (Mousa, 2011). Solichah & Fachrurrozi's research (2020), Stephen et al. (2016), and El-Bannany (2017) found that firm size has a significant positive effect on accounting conservatism, while research by Octavia (2022) found that size of company has a significant negative effect on accounting conservatism. Based on previous theory and research, the hypothesis regarding the effect of firm size on accounting conservatism is as follows:

H3: Firm size has a significant positive effect on accounting conservatism.

Positive accounting theory explains the facets of political costs that high-profitability businesses bear. The company will apply the principle of conservatism due to the pressure of huge political costs (Watts & Zimmerman, 1990). Profitability can be related to the aspect of political costs, so conservatism is used by management to set profit levels to make it appear not to have high fluctuations (Octavia, 2022).

Octavia's research (2022), Dillak et al. (2017), and Yuningsih & Kalbuana (2020), which mentioned profitability has a significant positive effect on accounting conservatism, and research by

Teymouri & Sadeghi (2020) mentioned profitability has a negative influence on accounting conservatism. Based on the theory and previous research, the hypothesis in this study is as follows:

H4: Profitability has a significant positive effect on accounting conservatism.

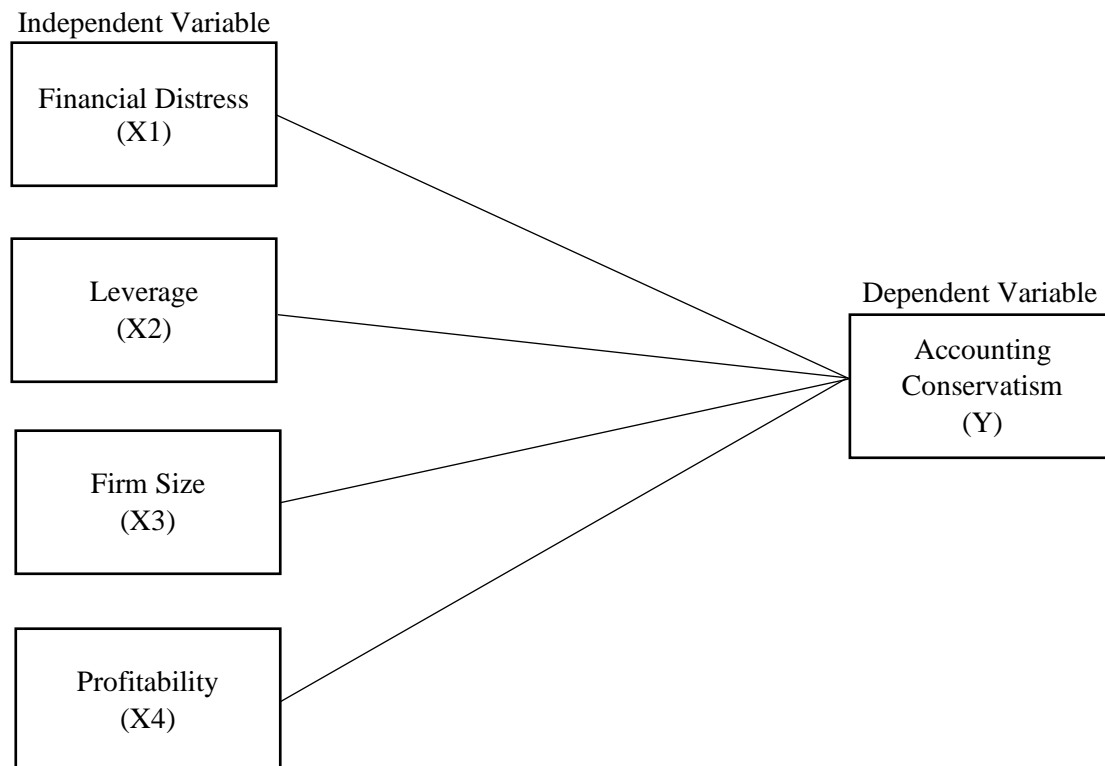


Figure 1. Framework

Methodology

Types of Research

This study uses a type of quantitative research. Analysis using statistical test tools was performed on manufacturing companies listed on the Indonesian Sharia Stock Index in 2017–2021. Quantitative research collects data, which then results from data analysis are used to test the hypothesis with all the data used in the form of numbers with the aim of testing and analyzing independent variables, namely financial distress, leverage, firm size, and profitability, on the dependent variable, namely accounting conservatism in the company manufacturers registered with ISSI in 2017–2021.

Population and Samples

Population and Samples The population used in this study is the company manufacturers listed on the Indonesian Sharia Stock Index (ISSI) for the period 2017–2021. Methods for determining the research sample using the purposive sampling technique. The purposive sampling method has certain criteria or considerations in determining the sample used in research. Criteria for determining the research sample to be used are as follows:

1. Manufacturing sector companies that have consistently been listed on ISSI over the years 2017–2021.
2. Companies that successively publish financial reports and their annual reports on the company's official website, or IDX, during the period 2017–2021.
3. Companies that use the rupiah currency report their finances.

Table 1. Variable Operation

No.	Variable	Measurement
1.	Dependent Variable Y = Accounting Conservatism	<p>Earning/accruals measure</p> $CONACC = \frac{(NI + DEP - CFO)}{TA} \times 1$ <p>Explanation: NI = Net Income DEP = Depreciation CFO = Operating Cash Flow TA = Total Assets</p>
2.	Independent Variable X ¹ = Financial Distress	<p>Altman Z-Score</p> $Z\text{-Score} = 6,56X1 + 3,26X2 + 6,72X3 + 1,05X4$ <p>Explanation: X1 = Working Capital / Total Assets X2 = Retained Earning / Total Assets X3 = EBIT/ Total Assets X4 = Equity Market Value /Total Liabilities</p>
3.	X ² = Leverage	$DER = \frac{\text{Total Liabilities}}{\text{Total Equity}}$
4.	X ³ = Firm Size	$\text{Log Natural (Total Assets)}$
5.	X ⁴ = Profitability	$ROA = \frac{\text{Net Profit}}{\text{Total Assets}}$

Results and Discussion

Descriptive statistics is a method used to collect, process, analyze, and present data in a descriptive manner at once, statistically describing the mean, median, standard deviation, minimum, and maximum values of the dependent and independent variables.

Table 2. Descriptive Statistic

	Accounting Conservatism	Financial Distress	Leverage	Firm Size	Profitability
Mean	-0.008424	3.469953	0.815884	28.45343	0.056730
Median	-0.011900	3.021600	0.616700	28.28750	0.048200
Max	0.849900	28.73220	5.442600	32.82040	0.921000
Min	-0.804000	-0.080700	0.022300	25.68950	-0.401400
Std. Dev.	0.103345	2.303748	0.705433	1.467941	0.096381
Skewness	0.364027	4.030947	2.320342	0.591397	2.190892
Kurtosis	27.24584	42.26495	11.62920	2.972665	23.42266

This study used 71 samples of manufacturing companies in 2017-2021 with a total of 355 observations. Presenting the results of the descriptive statistical test, it is known that the dependent variable, namely accounting conservatism, has a mean value of -0.008424, a median value of -0.011900, a maximum value of 0.849900, a minimum value of -0.804000, and a standard deviation value of 0.103345. The independent variable, namely financial distress, shows a mean value of 3.469953, a median value of 3.021600, a maximum value of 28.73220, a minimum value of -0.080700, and a standard deviation value of 2.303748. The leverage variable shows a mean value of 0.815884, a median value of 0.616700, a maximum value of 5.442600, a minimum value of 0.022300, and a standard deviation value of 0.705433. The firm size variable shows a mean value of 28.45343, a median value of 28.28750, a maximum value of 32.82040, a minimum value of 25.68950, and a standard deviation value

of 1.467941. The profitability variable shows a mean value of 0.056730, a median value of 0.048200, a maximum value of 0.921000, a minimum value of -0.401400, and a standard deviation value of 0.096381.

T-test Result

A partial significance test using the T-test result was done to look at how the independent variable affected the dependent variable. The test criteria were that if the probability value was less than 0.05, then the independent variable did affect the dependent variable. Conversely, if the probability value is > 0.05 , then the independent variable has no influence on the dependent variable. Results from the T test can be seen in the following table:

Table 3. T-test Result

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.117161	0.785965	-0.149066	0.8816
Financial Distress	0.068493	0.030213	2.266973	0.0243
Leverage	-0.021357	0.021039	-1.015118	0.3111
Firm Size	-0.004256	0.027264	-0.156101	0.8761
Profitability	0.039291	0.008439	4.655980	0.0000

Financial distress has t count of 2.266973 with a value probability 0.0243 ($p < 0.05$), so it can be interpreted that variable financial distress partially has a positive effect on accounting conservatism. Leverage variable has a t count of -1.015118 with a value probability of 0.3111 ($p > 0.05$), so it can be concluded that the leverage variable partially has no effect on accounting conservatism. Firm size has a t-count count of -0.156101 with a value probability of 0.8761 ($p > 0.05$), so it can be interpreted that firm size partially has no effect on accounting conservatism. Profitability variable has a t count of 4.655980 with a value probability of 0.0000 ($p < 0.05$), so it can be interpreted that the profitability variable partially has a significant effect on accounting conservatism.

F-Test Result

The f test is conducted to find out whether the independent variable simultaneously has an influence on the dependent variable. The results of the f test in this study can be seen as follows:

Table 4. F-test Result

F-Statistic	Prob
Prob (F-statistic)	0.000000

Based on the results of the F test above, it is known that the value of the probability of the F-Statistic is 0.000000, so that it shows a value probability < 0.05 , it can be concluded that the dependent variable, i.e., accounting conservatism, can simultaneously be influenced by independent variables, namely financial distress, leverage, firm size, and profitability.

Discussion

The first hypothesis in this study is that financial distress has a significant positive effect on accounting conservatism. Measurement of financial distress using the Altman z-score. Based on the results of the regression test, the financial distress variable obtained a t-count of 2.266973 and a significance value of 0.0243. These results indicate that the value of the significance of the financial distress variable is lower than 0.05, which means that the financial distress variable has a significant positive influence on accounting conservatism, and the first hypothesis of this research is accepted.

These results support the signal theory, which states that the agent will provide a signal by increasing accounting conservatism when the company is experiencing financial difficulties, principally to minimize the occurrence of information asymmetry (Ross, 1977). Companies that have a higher level of financial difficulty tend to reduce spending, which can exacerbate the conditions of the company, such as the cost of taxes charged by the government, by adopting accounting conservatism (Kao & Sie, 2016). In line with positive accounting theory, when the level of difficulty in corporate finance is high, it encourages companies to apply the principle of accounting conservatism in dealing with future uncertainty. These results are in line with research carried out by Loen (2021), which states that financial distress has a positive effect on accounting conservatism. The second hypothesis of this study is formulated to leverage a significant negative effect on accounting conservatism.

The second hypothesis of this study is formulated to leverage a significant negative effect on accounting conservatism. Leverage variable measurement using the debt-to-equity ratio. Based on the results of the regression test, the leverage variable is obtained by calculating the t value of -1.015118 and a significance value of 0.3111. These results show that the significance value of the leverage variable is higher than 0.05, which means that the leverage variable has no effect on accounting conservatism, and the second hypothesis in this study was rejected.

These results do not support the positive accounting theory hypothesis of debt agreements. This theory assesses if the level of leverage owned by high-level companies tends to cause management to not use principles of accounting conservatism to provide assurance of the security of funds lent to lenders (Ahyaruddin et al., 2022). Leverage owned by the company does not affect the application of conservatism because management will try to attract the giver's attention so that there is no termination of the debt contract (Fitriani & Ruchjana, 2020). These results are in line with the research conducted by Debora et al. (2022), who mention that leverage has no effect on accounting conservatism.

The third hypothesis in this study is that firm size has a significant positive effect on accounting conservatism. Firm size variable measurement uses the natural logarithm of total assets. The firm size variable obtains a calculated t value of -0.156101 and a significance value of 0.8761. This indicates that the significance value of the firm size variable is higher than 0.05 and can be interpreted to mean that the firm size variable has no effect on conservatism accounting, and the third hypothesis in this study was rejected.

These results do not support the positive accounting theory of the political cost hypothesis, which suggests that large companies will apply the principle of conservatism to reduce the tax burden (Hamdan, 2011).). Large companies are not always cost-sensitive in politics because they will be faced with large political costs. Larger company sizes sometimes want to show good financial performance and will tend to be optimistic in reporting finance. Companies that are optimistic about getting the attention of investors and creditors and gaining public trust rather than applying the principle of conservatism in order to minimize the tax burden (Septiana et al., 2021). The results of this study are consistent with research by Octavia (2022), which states that company size does not have an influence on the application of the principle of accounting conservatism.

The fourth hypothesis in this study is that profitability has a significant positive effect on conservatism in accounting. The measurement of the profitability variable uses return on assets. Based on the results of the regression test, the variable profitability obtained a calculated t value of 4.655980 and a significance value of 0.0000. These results indicate that the significance value of the profitability variable is lower than 0.05 and can be interpreted as indicating that the variable profitability has a significant positive effect on accounting conservatism, so it can be concluded that the fourth hypothesis in this study is accepted.

These results support the positive accounting theory on the cost hypothesis of politics, which mentions that companies with higher profitability have higher prices, which will increase the political costs faced (Debora et al., 2022). Thus, management tends to apply such accounting conservatism to set profits to look even and not too fluctuate (Putra & Sari, 2020). Companies that can generate large profits

will use the principle of accounting conservatism in order to maintain profits as a fixed or stable company (Debora, 2022). The results of this study are in harmony with the results of research conducted by (Dillak, 2017), which states that profitability has a significant positive effect on accounting conservatism.

Conclusions

This research was conducted to identify the influence of financial distress, leverage, firm size, and profitability on accounting conservatism. This study uses secondary data on manufacturing companies listed on the Indonesian Sharia Stock Index (ISSI) in 2017–2021. Based on the results of the regression analysis using the fixed effect model and discussion, the researcher draws the conclusion that financial distress, leverage, firm size, and profitability simultaneously affect conservatism and accounting. Partially, the financial distress and profitability variables have an effect on accounting conservatism, while leverage and firm size have no effect on accounting conservatism.

This study has many limitations, so there are several research suggestions for further research, as follows:

1. The dependent variable in this study is conservatism in accounting using earnings/accruals measures. It is hoped that further research will use a measurement model other than the net asset measure and the earnings/stock return relation measure so that the results of the research can be compared.
2. The research was conducted on other company sectors on the Stock Index Indonesian Sharia (ISSI) or other indices, such as mining, transportation, or banking, and added years of research to get the research results that were the newest and most diverse.
3. Research independent variables that do not explain much of the dependent variable, so it is advisable to update or add some other variables that can influence accounting conservatism, such as growth opportunity, managerial ownership, and intellectual capital, so that research has more accurate results and more coverage.

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