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The Role of Financial Distress, Profitability and Leverage on Accounting Conservatism

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ABSTRACT

This study aims to determine the effect of financial distress, profitability and leverage on accounting conservatism in Manufacturing Companies in the Consumer Goods Industry listed on the IDX for the 2017-2021 period. The type of research used is quantitative research. The data used is secondary data. The population is 63 companies and the sample technique uses purposive sampling method. Obtained a sample of 46 companies x 5 years = 230 financial statement data. The analysis used is the classical assumption test analysis method, panel data regression analysis and hypothesis testing.The results of this study prove that financial distress during the 2017-2021 research period has a significant influence on accounting conservatism, so that financial distress can affect the level of accounting conservatism in companies. The coefficient of the regression direction of financial distress is negative, meaning that when a company experiences financial distress it will encourage managers to reduce the level of accounting conservatism. Profitability was found to have no significant effect on Accounting Conservatism. Companies that have a high level of profitability will not tend to choose conservative accounting methods. Likewise leverage was found to have a significant effect on Accounting Conservatism. The higher the level of debt owned by the company means that the company's financial condition is not good, so managers tend to increase profits so that the financial condition looks good to creditors.

Keywords: Accounting Conservatism, Financial Distress, Leverage, Profitability

INTRODUCTION

Financial reports are a form of management accountability in managing company resources. Financial reports must meet the objectives, rules and accounting principles in accordance with generally accepted standards in order to produce financial reports that are accountable and useful for each user (Al-Muzaiqer, Ahmad, & Hamid, 2016). Generally accepted accounting standards provide flexibility for management in determining the accounting methods and estimates that can be used. Flexibility will affect the behavior of managers in recording accounting and reporting company financial transactions (Geanina, Hlaciuc, & Ursache, 2015). In conditions of doubt, a manager must apply conservatism accounting principles. Conservatism adheres to the principle of slowing down revenue recognition accelerating expense recognition (Sebrina & Taqwa, 2019; Yunos, Ismail, & Smith, 2012).

There is a case of low application of accounting conservatism in the presentation and disclosure of company financial reporting in the case of PT Garuda Indonesia, where in the 2018 financial statements PT Garuda Indonesia recorded a net profit of USD 809.85 thousand or the equivalent of IDR 11.33 (assuming an exchange rate of IDR 14,000 per US dollar). This figure jumped sharply compared to 2017 which suffered a loss of USD 216.5 million. PT Garuda Indonesia recorded the value of cooperation with PT Mahata Aero Technology worth USD 239 million, which is still in the nature of receivables but has been recognized as income by the management of PT. Garuda Indonesia. This proves that the company does not apply accounting conservatism in presenting financial statements. The existence of cases of financial manipulation can reduce the level of trust from users of a company's financial statements.

Factors that influence management in implementing conservatism, including financial distress (W. P. Sari, 2020; Widhiastuti & Rahayu, 2022). Financial distress is an early symptom of

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company bankruptcy due to a decline in the company's financial condition (Teymouri & Sadeghi, 2020). In signaling theory, it says that if a company experiences financial distress, it will encourage company managers to increase the level of accounting conservatism (Camacho-Miñano, Muñoz-Izquierdo, Pincus, & Wellmeyer, 2023; Chatterjee, Jia, Nguyen, Taylor, & Duong, 2023). Meanwhile, the positive accounting theory put forward by Watt and Zimmerman (1986) says that if a company experiences a high level of financial distress, it will encourage company managers to reduce the level of accounting conservatism.

Apart from financial distress, another factor that influences accounting conservatism is profitability (Khalilov & Osma, 2020; Shubita, 2021; Solichah & Fachrurrozie, 2019). Profitability, namely the ratio that shows the company's ability to generate profits (M. Sari & Rahma, 2022). The higher the level of profitability of a company, it will tend to choose conservative accounting to manage profits so that profits do not fluctuate greatly (Teymouri & Sadeghi, 2020).

Apart from financial distress and profitability, there are other factors that influence accounting conservatism, namely leverage (Machokoto, Chipeta, Aftab, & Areneke, 2021; Solichah & Fachrurrozie, 2019). Leverage is a ratio that shows how much debt is used to finance company assets (Chan, M'ng, Rahman, & Sannacy, 2017; Izobo ENAKIRERHI & Ify CHIJUKA, 2016; Mugoša, 2015; Öztekin, 2015). Based on the agency theory put forward by Jensen and Meckling (1976) there is a relationship between agents (company management) and principals (shareholders) in a company. Agency theory explains that if a company has a high level of debt, the company will increasingly apply the principle of conservatism.

The research objectives to be achieved with this research are to determine the partial effect of financial distress, profitability and leverage on accounting conservatism in Manufacturing Companies in the Consumer Goods Industry Sector listed on the Indonesia Stock Exchange for the 2017-2021 period, and to determine the effect of financial distress, profitability and leverage simultaneously on accounting conservatism in Manufacturing Companies in the Consumer Goods Industry Sector listed on the Indonesia Stock Exchange for the 2017-2021 Period.

LITERATURE STUDY

Financial distress

Financial distress is a condition of financial decline experienced by a company for several consecutive years which can result in bankruptcy (Adiwibowo, Rohmah, & Nurmala, 2023). Khaliq et al (2014) defines financial distress as a condition in which a company cannot or experiencing difficulties in fulfilling its obligations to creditors. The chance of financial distress increases when the company's fixed costs are high, liquid assets, or earnings are very sensitive to economic recession (Kisman & Krisandi, 2019). This condition will force companies to incur high costs so that management is forced to make loans to other parties. Baimwera & Muriuki (2014) also defines financial distress as the possibility that a company cannot fulfill its obligations when they fall due. In the event of financial difficulties, the company's inability to fulfill its obligations indicates that the company lacks working capital. This shortage of working capital can be caused by several factors, such as current liabilities and operating costs that are too high. If the company experiences financial distress and there is no further action for improvement, the company may experience bankruptcy and may even be liquidated. Bankruptcy is a situation where the company fails or is no longer able to fulfill all the obligations of the lender (debtor) because of the company lack of funds to run and continue their business so that the achievement of economic goals is not fulfilled (Pratama, 2022).

Based on the above understanding, it can be interpreted that financial distress is a situation in which a company experiences financial difficulties which is characterized by the cash flow generated by the company being insufficient to meet long-term and short-term obligations and the company is required to carry out corrections to company activities. Financial distress can also cause a company to go bankrupt and be forced to take action to improve cash flow.

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Profitability

Profitability is a company's ability to generate profits within a certain period of time (Khalilov & Osma, 2020; Shubita, 2021). This profit is the net result of a series of policies and decisions and is related to sales, total assets, and equity (Sartono, 2010). Profitability is a measure of the effectiveness of company management by management (Purba & Africa, 2019). The effectiveness of company management by management will generate optimal profits for the company and will indirectly increase profits for shareholders. According to Kasmir (2012: 196) the profitability ratio is the ratio to assess the company's ability to make a profit. This ratio also provides a measure of the effectiveness of a company's management. This is demonstrated by the profit generated from sales and investment income. The point is the use of this ratio shows the efficiency of the company. Furthermore, Siagian, Wijoyo, & Cahyono (2021) argues, the use of profitability ratios can be done by using comparisons between various components in financial reports, especially financial reports, balance sheet and income statement. Measurements can be made for several operating periods. The goal is to see the development of the company in a certain time span, either decreasing or increasing as well as looking for the causes of these changes. Profitability ratios can be measured from two approaches, namely the sales approach and the investment approach. The measures that are widely used are Return on Assets (ROA) and Return on Equity (ROE), the profitability ratios measured from ROA and ROE reflect business attractiveness.

Leverage

Leverage is the use of fixed-cost assets and capital by companies with the aim of increasing potential returns to shareholders (Segal & Ólafsson, 2023). Increased profit potential is achieved through various policies regarding investment or obtaining funding sources along with fixed costs or expenses incurred by the company (Chen, Kumara & Sivakumar, 2021). According to Jin & Xu, (2022), financial leverage is the practice of funding part of a company's assets with securities that bear a fixed return burden in the hope of increasing the final return for shareholders. The leverage ratio is a measure of how much the company is financed with debt (Siswanto, Maudhiky, Wahyudi, &, & Rahmat Syah, 2022). The use of debt that is too high will endanger the company because the company will be included in the extreme leverage category, namely the company is trapped in a high level of debt and it is difficult to release the debt burden. Because of that, the company should have to balance several debts that are worth taking and from which sources that can be used to pay debts. Meanwhile, solvency is the company's ability to fulfill all of its obligations (both short term and long term), if the company is liquidated at that time.

Solvability ratios are often known as leverage ratios which measure the contribution of owners (financiers or shareholders) compared to funds originating from creditors. Based on the definition above, it can be interpreted that leverage indicates the company's ability to meet both short-term and long-term obligations. The leverage ratio that is commonly used is the debt ratio, namely total debt divided by total assets. The lower the debt ratio, the better the condition of the company. This means that only a small part of the company's assets are financed with debt.

METHOD

This research is a quantitative research that emphasizes its analysis on numerical data processed by statistical methods. This research is causal in nature, namely to see the relationship between variables (Nurlan, 2019).

Population and Research Sample

The population in this study are Manufacturing companies in the Consumer Goods Industry sector which are listed on the IDX for the 2017-2021 period. The sampling technique was carried out using a purposive sampling method, namely the selection of samples with certain criteria. The number of samples in this study were 46 companies.

Method of collecting data

This research data uses secondary data, secondary data is data obtained indirectly to obtain

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information from the object under study. The data collection method for this research is by downloading the annual financial reports of Manufacturing companies in the Consumer Goods Industry sector which are listed on the IDX for the 2017-2021 period through the official website of the Indonesia Stock Exchange, namely www.idx.co.id.

Accounting Conservatism (Y)

The principle of conservatism is a concept that recognizes expenses and obligations as soon as possible even though there is uncertainty about the results, but only recognizes income and assets when it is certain that they will be received (Savitri, 2016). Accounting conservatism as the dependent variable is calculated using accrual model (Givoly & Hayn, 2000).

Financial Distress (X1)

Financial distress is a situation where a company experiences financial difficulties which is characterized by the cash flow generated by the company being insufficient to meet long-term and short-term obligations and the company is required to make corrections to company activities (Sutra and Mais, 2019). The financial distress of a company can be measured through financial reports, using the Modified Altman Z-score model, with the formula:

$$Z'' = 6{,}56X1 + 3{,}26X2 + 6{,}72X3 + 1{,}05X4$$

Keterangan:

X1: *working capital to total assets*
X2: *retained earning to total assets*
X3: *earning before interest and taxes tototal assets*
X4: *book value of equity to book value oftotal debt*
Z: *bankrutpcy index*

Profitability (X2)

Profitability is the company's ability to generate profits. Profits can vary, depending on the needs of the profit measurement (Izobo ENAKIRERHI & Ify CHIJUKA, 2016).

Leverage (X3)

Leverage is the ratio used to measure the extent to which a company's assets are financed with debt (Öztekin, 2015). The leverage variable is measured by the Debt to Asset Ratio ratio.

Regression Model Selection

There are three approaches to estimating the panel data regression model using the Eviews 9 analysis tool, namely the Common Effect Model, Fixed Effect Model, and Random Effect Model. Then do the Chow Test, Hausman Test and Lagrange Multiplier Test.

Descriptive Statistical Data Analysis Methods

These descriptive statistics are used to describe and provide an overview of statistical research data for each variable in the study.

Panel Data Regression Analysis

Panel data is a combination of cross section data and time series data (Widarjono, 2007).

Hypothesis testing

Partial Test (t test)

Partial test was conducted to determine the effect of each independent variable on the dependent variable partially.

Simultaneous Test (Test F)

Simultaneous tests were carried out to determine the effect of the independent variables together on the dependent variable.

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RESULTS AND DISCUSSION

Results

The companies that are the sample in this study are manufacturing companies in the consumer goods industry sector which are listed on the Indonesia Stock Exchange for the 2017-2021 period. The sampling method used in this study was a purposive sampling method in which 46 companies were obtained that met the sampling criteria with a span of 5 years, so that the total data was 230 data. Data analysis begins by tabulating the data using Microsoft Excel, then the data is processed using the EViews 9 program.

Descriptive statistics

Table 1. Descriptive Statistics

	Y	X1	X2	X3
Mean	0.000445	7.202138	0.133752	0.434240
Maximum	2.980277	17.11040	2.244585	2.899874
Minimum	-0.804033	-24.05727	-1.666384	0.065126
Std. Dev.	0.230491	4.327447	0.345562	0.304605
Observations	230	230	230	230

Source: Data Processed (2022)

Hypothesis testing

Table 2. Fixed Effect Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.541727	0.070234	7.713196	0.0000
X1	-0.058100	0.006019	-9.652067	0.0000
X2	-0.018390	0.029342	-0.626735	0.5316
X3	-0.277216	0.082073	-3.377677	0.0009
R-squared	0.620156	Mean dependent var		-0.005882
Adjusted R-squared	0.519423	S.D. dependent var		0.204817
S.E. of regression	0.142031	Sum squared resid		3.651289
F-statistic	6.156477	Durbin-Watson stat		2.064957
Prob(F-statistic)	0.000000			

Source: Data Processed (2022)

Based on the results of descriptive statistical analysis, it can be seen that the sample used in this research was 230 observations. The average value of the accounting conservatism variable (Y) is 0.000445 with a standard deviation of 0.230491. Financial distress variable (X2) with an average value of 7.202138, a standard deviation of 4.327447, a minimum value of -24.05727 and a maximum value of 17.11040.

The results of descriptive statistical analysis of the Profitability variable (X2) with an average value of 0.133752 with a standard deviation of 0.345562, a minimum value of - 1.666384 and a maximum value of 2.244585. The results of the descriptive statistical analysis of the Leverage

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variable (X3) with an average value of 0.434240 with a standard deviation of 0.304605, a minimum value of 0.065126 and a maximum value of 2.899874.

Partial Test (t test)

From the Fixed Effect Model table above, it can be seen that the significant value of t Financial Sidtress (X1) is 0.0000. It can be seen that the significant value of t variable Financial Distress is 0.0000 <0.05. It was concluded that Financial Distress has a partially significant effect on Accounting Conservatism. The significant value of t Profitability (X2) is 0.5316. It can be concluded that the significant value of t variable Profitability is 0.5316 > 0.05. It is concluded that Profitability has no significant effect partially on Accounting Conservatism. The significant value of t Leverage (X3) is 0.0009. It can be concluded that the significant value of t variable Leverage is 0.0009 <0.05. It was concluded that Leverage has a partially significant effect on Accounting Conservatism.

Simultaneous Test (Test F)

From the Fixed Effect Model table above, it shows a significant F value of 0.000000. So because 0.000000<0.05, it can be concluded that Financial Distress, Profitability and Leverage affect Accounting Conservatism together.

Panel Data Regression Analysis Test

$$Y= 0.541727 - 0.058100(X1) - 0.018390(X2) - 0.277216(X3) + e$$

A constant value (α) of 0.541727 indicates a constant value, where if all the independent variables namely Financial Distress, Profitability and Leverage have a value of 0, then the level of the dependent variable namely Accounting Conservatism is 0.541727. The financial distress coefficient value of -0.058100 indicates that the financial distress variable changes every 1 unit while other variables remain the same, it will reduce the accounting conservatism variable by 0.058100. The profitability coefficient value of -0.018390 indicates that the profitability variable changes by 1 unit every time while the other variables are constant, it will cause a decrease in the conservatism variable by 0.0018390. The leverage coefficient value is -0.277216 indicating that the leverage variable changes by 1 unit every time while other variables remain the same, it will increase the conservatism variable by 0.277216.

Discussion

Financial Distress on Accounting Conservatism

The results of the Financial Distress (X1) variable t test based on the Fixed Effect Model table have a coefficient value of -0.058100 and a significant value of 0.0000 is obtained. Value 0.0000 <0.05. The results of this study prove that financial distress during the 2017-2021 research period has a significant influence on accounting conservatism, so that financial distress can affect the level of accounting conservatism in companies. The coefficient of the regression direction of financial distress is negative, meaning that when a company experiences financial distress it will encourage managers to reduce the level of accounting conservatism. The results of this study are contrary to the signal theory which states that the higher the level of financial distress, the company will increase accounting conservatism. However, this study is in accordance with positive accounting theory (Watt and Zimmerman, 1986) which states that the higher the level of financial distress, the company will lower the level of accounting conservatism. The results of this study are in accordance with the hypothesis formulated earlier. The research hypothesis explains that financial distress has a significant effect on accounting conservatism, so it can be concluded that H1 is accepted. The results of this study support the results of previous research conducted by Sulastri & Anna (2018) which concluded that financial distress has a significant effect on accounting conservatism.

Profitability on Accounting Conservatism

The results of the Profitability variable t test test (X2) based on the Fixed Effect Model table have a coefficient value of -0.018390 and a significant value of 0.5316 is obtained. Value 0.5316 > 0.05.

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The results of this study indicate that companies that have a high level of profitability will not tend to choose conservative accounting methods. This is because the company wants to give a signal to investors and also the public that the company is positive in the future so that when profits are high the company does not need to consider the principle of accounting conservatism and also shows the use of its own capital to generate effective profits. The results of this study are not in accordance with positive accounting theory and signal theory which suggest that the more companies have high profitability, the more companies will apply the principle of accounting conservatism. The results of this study are also not in accordance with the hypotheses that have been formulated previously. The research hypothesis explains that profitability has a significant effect on accounting conservatism so that it can be concluded that H2 is rejected. The results of this study support the results of research conducted by Sapitri, Hakim, & Abbas (2021) which concluded that profitability has no significant effect on accounting conservatism.

Leverage on Accounting Conservatism

The results of the Leverage variable t test (X3) based on the Fixed Effect Model table have a coefficient value of -0.277216 and a significant value of 0.0009 is obtained. Value 0.0009 <0.05. The higher the level of debt owned by the company means that the company's financial condition is not good, so managers tend to increase profits so that the financial condition looks good to creditors. The amount of debt does not guarantee the company to be more careful in making decisions, it is suspected that creditors do not supervise the company's operations and accounting. The coefficient of the leverage regression direction is negative, this is in the opposite direction to agency theory which explains that if a company experiences a high level of debt, the company will increasingly apply the principle of accounting conservatism. Because this research proves that a high level of leverage causes a company's financial statements to tend to be non-conservative, in other words, companies choose accounting methods that increase company profits. These results are in accordance with the hypothesis that has been formulated previously. The research hypothesis explains that leverage has a significant effect on accounting conservatism, so it can be concluded that H3 is accepted. The results of this study support the results of research conducted by Sulastri & Anna (2018) which concluded that leverage has a significant effect on accounting conservatism.

Financial Distress, Profitability and Leverage simultaneously on Accounting Conservatism

Based on the significant F test results of 0.000000 <0.05, it can be concluded that Financial Distress, Profitability and Leverage simultaneously influence Accounting Conservatism, so the H4 hypothesis is accepted. The results of this study support the results of research conducted by Putra & Sari (2020) which concluded that financial distress, profitability and leverage has a significant effect simultaneously on accounting conservatism.

CONCLUSION

Based on the results of research and discussion regarding the effect of financial distress, profitability and leverage on accounting conservatism, it can be concluded that partially the variables financial distress (X1) and leverage (X3) have a significant effect on accounting conservatism in Manufacturing Companies in the Consumer Goods Industry Sector listed on the IDX for the 2017-2021 period. Meanwhile, profitability (X2) has no significant effect on accounting conservatism in Manufacturing companies in the Consumer Goods Industry Sector listed on the IDX for the 2017-2021 period. Simultaneously Financial Distress, Profitability and Leverage have a significant effect on Accounting Conservatism in Manufacturing companies in the Consumer Goods Industry Sector listed on the IDX for the 2017-2021 period. Based on the conclusions and discussion, the researcher suggests to future researchers to expand the scope of research, not only in Manufacturing companies in the Consumer Goods Industry Sector but also in the mining, financial, property and real estate sectors. And researchers suggest in future research to add other independent variables that can affect accounting conservatism such as Investment Opportunity Set, company size, capital intensity, litigation risk and others.

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