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# The Role of Financial Distress in Mediating The Accounting Conservatism Practices

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**Abstract**

*Conservatism is a prudent reaction to uncertain conditions aimed at protecting the rights and interests of shareholders, and lenders who determine higher standard verification to recognize good news rather than bad news. Several phenomena that indicate the lack of application of accounting conservatism are the many fraudulent acts of internal company parties. This study aimed to determine the effect of the board of directors, firm size, leverage on accounting conservatism through financial distress as a mediating variable. The population of this research is manufacturing companies listed on the Indonesia Stock Exchange in 2016-2018. The research sample was determined by purposive sampling method so that there were 174 analysis units. The data use published annual reports. The analysis tool used descriptive analysis and path analysis. The results showed that financial distress, firm size, and leverage had a significant positive, but the board of directors had no effect on accounting conservatism. The board of directors and leverage had a significant negative effect on financial distress. Firm size had a significant positive effect on financial distress. Financial distress significantly mediated the effect of firm size and leverage, but was unable to mediate the effect of the board of directors on accounting conservatism.*
**Keywords:** ***Accounting Conservatism; Board of Directors; Financial Distress; Firm Size; Leverage***

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## INTRODUCTION

The application of the principle of accounting conservatism is considered capable of being the most rational guide in dealing with difficult situations experienced by companies. This is because the application of the principle of accounting conservatism can reduce agency costs so that the resulting financial statements are more accurate, quality, accountable, provide transparent information, and do not mislead decision maker (Putri et al., 2017). This is supported by Putra et al. (2019) who stated that conservatism is a prudent reaction to uncertain conditions aimed at protecting the rights and interests of shareholders, and lenders who determine higher standard verification to recognize good news rather than bad news. However, the application of accounting conservatism in Indonesia is still low.

Several phenomena that indicate the lack of application of accounting conservatism are the many fraudulent acts of internal company parties. Among them, the first case, namely the case that occurred at Toshiba in May 2015 is known to have made various efforts, one of which is through accounting fraud worth US $ 1.22 billion, resulting in profits that do not match reality (Integrity, 2017). Another case occurred at PT Timah (Persero) Tbk. which was suspected of having carried out fictitious financial reporting in the first semester of 2015 to cover up the worrisome financial performance of PT Timah (Persero). PT Timah (Persero) Tbk. committed such fraud by increasing the company's profit to cover the loss of operating profit which reached Rp. 59 billion. Another phenomenon that occurred in June 2019 was related to irregularities in the financial statements of PT Garuda Indonesia. Garuda Indonesia should have recorded a current year's loss of US $ 244.95 million, it was recorded a current year's profit of US $ 5.01 million. This happened because of the recorded income of US $ 239.94 million. This income should not be recognized in the 2018 financial year (Aldin, 2019). Considering that there are several cases of companies that present financial reports that tend to be overstated, the application of this conservatism needs to be considered so as not to mislead users of financial reports and to produce useful and quality financial information.

Theories related to the application of accounting conservatism include agency theory, signaling theory, and positive accounting theory. The difference in interests between the agent and the principal can lead to the emergence of several agency problems. The second theory related to the application of accounting conservatism is signaling theory. Signaling theory explains that managers provide signals to reduce information asymmetry (Sulastri et al., 2018a). The third theory related to the application of accounting conservatism is positive accounting theory. The positive accounting theory explains that the application of conservatism is based on three hypotheses, namely the bonus plan hypothesis, the debt covenant hypothesis, and the political cost hypothesis.

The board of directors is a part of the company that is fully responsible for the management of the company and is one of the most important parts of the corporate governance mechanism because a large number of boards of directors can assist the company in making policies that are beneficial to the company so that it can benefit the company and provide value added for the company (Sastriana & Fuad, 2013). Agency theory explains the agency problem that occurs due to differences in interests between the agent and the principal. Therefore, to overcome this, the board of directors as one of the components of good corporate governance, which in this case acts as an agent, will apply the principle of accounting conservatism in corporate financial reporting, to overcome the agency problem, because agency problems will certainly provide a lot negative impact on the company itself, both in terms of financial and in terms of principal trust. Several previous studies have shown inconsistent results regarding the effect of the board of directors on accounting conservatism. Kootanaee (2013) in his research stated that the board of directors had no effect on accounting conservatism. Meanwhile, Ammy (2016); Mohammed et al. (2019) in their research stated that the board of directors had a significant positive effect on accounting conservatism. Meanwhile, Amran et al. (2014); Hani (2012); Nasr & Ntim (2018); Suleiman & Mutalib.Anifowose (2014) in their research stated that the board of directors had a significant negative effect on accounting conservatism.

Firm size is the level of company size which is reflected from the number of assets owned by a company. The bigger a company is, the government will allocate more political costs to the company (Purnama & Daljono, 2013). The positive accounting theory on the political cost hypothesis explains that in a ceteris paribus condition, companies that have the possibility of large political costs will try to defer profits from the present period to the future periods, so that large companies will tend to postpone their profits to the future. This is done so that large companies that the government tends to pay attention to can reduce their political costs. Purnama & Daljono (2013; Sulastri et al. (2018b) found that firm size had a

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significant positive effect on accounting conservatism. Meanwhile, Alfian & Sabeni (2013); Maharani & Kristanti (2019); Priambodo & Purwanto (2015); Sinambela & Almilia (2018); Sumiari & Wirama (2016) in their research stated that firm size had no effect on accounting conservatism. Other research conducted by Hertina & Zulaikha (2017) stated that firm size had a significant negative effect on accounting conservatism, Affianti & Supriyati (2019) find that firm size has no significant effect on accounting conservatism level.

Leverage shows how much the company's operating costs are financed by external debt. In Watts' positive accounting theory, Watts & Zimmerman (1990) formulated three hypotheses that discuss the application of accounting conservatism. One of the three hypotheses is the debt covenant hypothesis which explains that in a ceteris paribus condition, companies that have a high leverage ratio will tend to choose accounting procedures that shift future earnings reporting to the current period, so that the leverage ratio will tend to decrease. This is done because the company in getting debt must meet the requirements given by creditors such as maintaining the company's financial ratios. Therefore, it can be said that companies that have a leverage ratio will reduce the application of accounting conservatism. \ Brilianti (2013); Maharani & Kristanti (2019); Priambodo & Purwanto (2015); Purnama & Daljono (2013); Sinambela & Almilia (2018) in their research stated that leverage had no effect on accounting conservatism. Meanwhile, Sulastri et al. (2018b) in their research found that leverage had a significant positive effect on accounting conservatism. Meanwhile, Putri et al. (2017) stated that leverage had a significant negative effect on accounting conservatism.

Financial distress is one of the early warnings of a company bankruptcy (Ramadhoni et al., 2014). Therefore, financial distress will cause companies to tend to be careful in taking action because each action will be more risks than when it does not experience financial difficulties. Signaling theory states that the company will provide a signal to reduce information asymmetry between interested parties in the company. Companies experiencing financial difficulties will tend to use accounting conservatism methods to reduce information asymmetry and maintain creditor and investor confidence in the company by generating quality profits. Companies that are experiencing financial distress must be increasingly careful in dealing with uncertainty, therefore it is necessary to apply accounting conservatism. Research conducted by Putri et al. (2017); S Rahayu et al. (2018) proved that financial distress had a positive effect on accounting conservatism. Meanwhile, other research conducted by Lestari Dewi & Suryanawa (2014); Rivandi & Ariska (2019); Sumiari & Wirama (2016) stated that financial distress had a significant negative effect on accounting conservatism. Putri et al. (2017); Septianto (2016) in their research actually showed that financial distress had no effect on the application of accounting conservatism.

Based on the phenomenon and the results of previous research which are still inconsistent, this study aims to determine the effect of the board of directors, company size, and leverage on accounting conservatism through financial stress as a mediating variable. The difference between this study and previous research is that it presents the financial distress variable as a mediation.

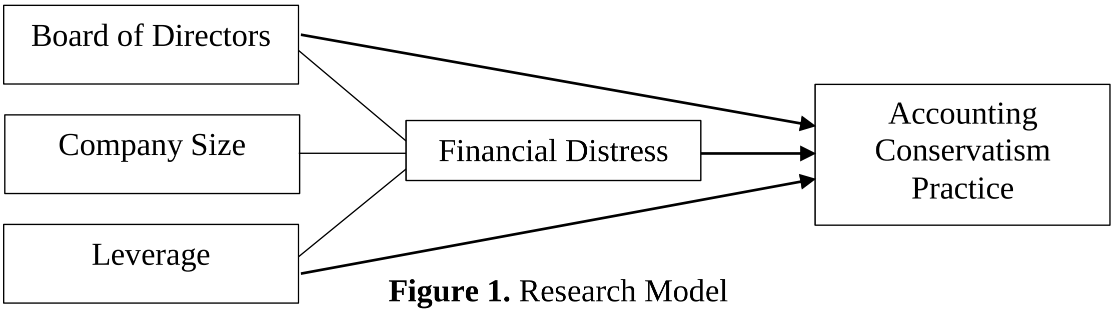


**Figure 1.** Research Model

## RESEARCH METHOD

The population in this study were manufacturing companies listed on the Indonesia Stock Exchange (IDX) in 2016-2018. The sample selection in this study used purposive sampling. The criteria for taking sample includes: (1) Manufacturing companies listed on the Indonesia Stock Exchange (IDX) throughout 2016-2018; (2) Manufacturing companies that publish annual financial reports on the official website of the Indonesia Stock Exchange for 2016-2018; (3) Manufacturing companies that present financial reports using the rupiah currency; (5) Manufacturing companies that have complete data on research variables. Based on the data tabulation, it is known that the number of manufacturing companies listed on the Indonesia Stock Exchange (IDX) in 2016-2018 is 138 companies. Based on the criteria for determining the sample, 174 units of research analysis were produced consisting of 58 manufacturing companies with 3 periods of financial statement accounting. The variables used in this study are accounting conservatism as the dependent variable, board of directors, firm size, leverage as independent variables, and financial distress as the mediating variable. The analysis tool used descriptive analysis and path analysis. The operational definition of each research variable can be seen in Table 1. below. While the regression equation for path analysis follows.

$$FD = a + b_1BD + b_2SIZE + b_3LEV + e_1 \quad \text{……………………... (1)}$$

$$AC = a + b_1BD + b_2SIZE + b_3LEV + b_4FD + e_2 \quad \text{……………………... (2)}$$

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**Table 1.** The Operational Definition of Each Variable

| No | Variable | Variable Definition | Measurement |
|---|---|---|---|
| 1 | Accounting Conservatism (AC) | Accounting conservatism is defined as the principle of prudence in financial reporting where the company does not rush to recognize and measure assets and profits and immediately recognize the possible losses and debts. | $CONACC = \frac{NI + DEP - CFO)\ x\ (-1)}{TA}$ (Savitri, 2016) |
| 2 | Financial Distress (FD) | Financial distress begins when the company is unable to meet payment schedules or when cash flow projections indicate that the company will soon be unable to meet its obligations. | $X = -4{,}3 - 4{,}5X_1 + 5{,}7X_2 + 0{,}004X_3$ |
| 3 | Board of Directors (BD) | The board of directors is the agent in charge of managing the resources owned by the company | The board of directors = The number of the board of directors (Ananto et al., 2017) |
| 4 | Firm Size (SIZE) | Firm size is a scale in which a company can be classified as large or small according to various ways, including total assets, net sales, and market capitalization. | Size = Ln (Total Assets) (Purnama & Daljono, 2013) |
| 5 | *Leverage* (LEV) | The leverage ratio is used by the company to measure the condition of the company's ability to pay its long-term obligations, assessed from debt compared to the company's assets or with its own capital. | *Leverage = Debt to asset ratio* (Nasr & Ntim, 2018) |

Source: Results of Previous Research, 2020

## RESULTS AND DISCUSSION

The results of the descriptive analysis test showed that the distribution of research data in detail was described in Table 2. The mean of application of accounting conservatism showed a value 3.6245. The mean of financial distress showed a value of 3.3780. The board of directors was 5.89. Firm size sowed the mean of 28.5941, while the mean of the debt asset ratio as a proxy for measuring leverage showed a value of 0.4127.

**Table 2.** Results of the Descriptive Statistical Analysis of Research Variables

| Descriptive Statistics | | | | | |
|---|---|---|---|---|---|
| | N | Minimum | Maximum | Mean | Std. Deviation |
| BD | 174 | 2 | 16 | 5,89 | 2,614 |
| SIZE | 174 | 25,64 | 32,20 | 28,5941 | 1,46606 |
| LEV | 174 | ,00 | 1,25 | ,4127 | 0,24862 |
| FD | 174 | -1,15 | 27,63 | 3,3780 | 4,26421 |
| AC | 174 | ,11 | 62,93 | 3,6245 | 8,21395 |
| Valid N (listwise) | 174 | | | | |

Source: Secondary data processed, 2020.

Before testing the hypothesis, a classic assumption test was carried out which included the normality test, heteroscedasticity test, autocorrelation test, and multicollinearity test. Because this study used path analysis, in this study there were two regression models that needed to be tested classic assumptions, namely the first model using accounting conservatism as the dependent variable and the second model using financial distress as the dependent variable. Based on the results of the analysis, it can be seen that the two models met all the requirements of the classical assumption test. Where based on the results of One-Sample Kolmogorov-Smirnov, the two models avoided normality problems because the significance value showed a value greater than 0.05. The multicollinearity test results showed that all the variables used had a tolerance value of more than 0.1 and a VIF value of less than 10, therefore it can be said that the model avoided the problem of multicollinearity in both model one and model two. The output of the park test was used to test for heteroscedasticity symptoms in this study. In both models, the significance value of each variable on the natural logarithm of the residual value in each model had a value of more than 0.05. Therefore, it can be concluded that both models avoided heteroscedasticity symptoms. The autocorrelation test was carried out using the Run Test and it was known that the asymp value. Sig. (2-tailed) in each model showed a value of more than 0.05.

Adjusted R Square in model one showed a value of 0.467, while model two showed a value of 0.238. These results indicated that the board of directors, firm size, leverage, and financial distress had a contribution of 46.7% in influencing accounting conservatism. In addition, 23.8% of the company's financial distress was influenced by the board of directors, firm size, and leverage. The results of hypothesis testing can be seen in Table 3.

**Table 3.** Results of Hypothesis Test

| **Hypothesis** | **Beta** | **Sig.** | **α** | **Result** |
|---|---|---|---|---|
| The board of directors has a significant negative effect on accounting conservatism | 0,029 | 0,335 | 0,05 | Rejected |
| Firm size has a significant positive effect on accounting conservatism | 0,172 | 0,002 | 0,05 | Accepted |
| Leverage has a significant negative effect on accounting conservatism | 1,551 | 0,298 | 0,05 | Rejected |
| Financial distress has a significant positive effect on accounting conservatism | 0,153 | 0,000 | 0,05 | Accepted |
| The board of directors has a significant negative effect on financial distress | -0,071 | 0,039 | 0,05 | Accepted |
| Firm size has a significant positive effect on financial distress | 0,279 | 0,000 | 0,05 | Accepted |
| Leverage has a significant negative effect on financial distress | -1,993 | 0,000 | 0,05 | Accepted |
| The board of directors has a significant positive effect on accounting conservatism through financial distress as a mediating variable | -0.010 | 0,068 | 0,05 | Rejected |
| Firm size has a significant positive effect on accounting conservatism through financial distress as a mediating variable | 0,043 | 0,000 | 0,05 | Accepted |
| Leverage has a significant negative effect on accounting conservatism through financial distress as a mediating variable | -0.305 | 0,000 | 0,05 | Accepted |

Source: Secondary data processed, 2020.

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Hypothesis test results indicated that the board of directors had no effect on accounting conservatism. These results were not in line with agency theory which explains that the board of directors as a component of good corporate governance will apply the principle of accounting conservatism to overcome any agency problems that may occur, because the agency problem will certainly have many negative impacts on the company itself both in terms of financial and in terms of principal's trust. The results of this study can be due to several factors, because in this study the board of directors was proxied by using the number of the board of directors of the company, so that it cannot reflect the quality and effectiveness of the board of directors in making company decisions, including in terms of the application of accounting conservatism in financial reporting. Using an independent board proxy could be an option to increase the role of more oversight in accounting policy selection practices. The results of this study were in line with research conducted by Ahmed & Duellman (2007); Elshandidy & Hassanein (2014) in their research which stated that the board of directors had no effect on accounting conservatism.

The results of this study indicated that firm size had a significant positive effect on accounting conservatism. The results of this study supported the political cost hypothesis on the positive accounting theory which explains that in a ceteris paribus condition, companies that have a high probability of political costs will try to postpone the current period's profit to the future period. Political costs themselves can come from taxes imposed by the government on assets owned by a company. Meanwhile, the size of the company in this study was proxied by the natural logarithm of the company's total assets. Therefore, the greater the size of a company, the higher the tax imposed by the company. This is certainly considered to be less profitable, because it will reduce the value of profits that the company receives itself so company will choose to apply accounting conservatism to overcome this. The results of this study were in line with research conducted by Purnama & Daljono (2013); Sulastri et al.(2018b) who in their research found that firm size had a significant positive effect on accounting conservatism.

Based on the results of hypothesis testing, it was known that leverage had a significant positive effect on accounting conservatism. These results did not support the positive accounting theory which explains that in a ceteris paribus condition, companies that have a high leverage ratio will tend to choose accounting procedures that shift future earnings reporting to the current period, so that the leverage ratio will tend to decrease. These results can be due to several factors, because the company realizes that if you choose an accounting procedure that shifts future earnings reporting to the current period it will result in overstate earnings, and this can have a bigger negative impact on the company in the future. In addition, the company maintains the application of accounting conservatism because it wants to maintain the trust of creditors and investors by producing quality financial reports. Therefore, it can be said that companies with high leverage ratios will increasingly apply accounting conservatism. The results of this study were in line with research conducted by Alfian & Sabeni (2013); Hertina & Zulaikha (2017); Lestari Dewi & Suryanawa (2014); S Rahayu et al. (2018); Sulastri et al. (2018b) in their research found that leverage had a significant positive effect on accounting conservatism.

Based on the results of hypothesis testing, it was known that financial distress had a significant positive effect on accounting conservatism. These results supported the signal theory which explains that management will try to reduce information asymmetry that occurs within the company to avoid any negative impacts on the company in the future. The application of accounting conservatism is a positive signal given by management to investors that the company has provided quality earnings and continues to receive good assessments from investors (Sulastri et al., 2018b). In addition, the application of accounting conservatism is intended so that companies are careful in making decisions, and establish policies for the future in order to overcome financial distress and minimize risks that may occur in the future. The results of this study were in line with the results of research conducted by Putri et al. (2017); S Rahayu et al. (2018) who found that financial distress had a significant positive effect on accounting conservatism.

The results of this study indicated that the board of directors had a significant negative effect on financial distress. This may imply that the greater the board of directors a company has, it can result in a decrease in the company's financial distress itself. In agency theory, the board of directors is an agent in charge of managing the resources owned by the company, and is authorized and fully responsible for the management of the company for the interests of the company, both inside and outside the court in accordance with the articles of association. The more boards of directors the company has, the more ideas or ideas that arise from each board of directors to manage the company well, in order to overcome the financial distress facing the company itself. The results of this study were in line with research conducted by Manzaneque et al. (2016); Salloum et al. (2013); Sastriana & Fuad (2013) who in their research stated that the board of directors had a negative effect on financial distress.

The results of this study indicated that firm size had a significant positive effect on financial distress. This means that the greater the size of a company, the greater the company's financial distress. In positive accounting theory, Watts & Zimmerman (1990) hypothesized that the political costs of a company will increase according to the size of the company. The larger the size of a company, the higher the political costs imposed on the company. The existence of higher political costs will result in decreased company profits, and if this happens continuously it can cause the company to experience financial distress. The results of this study were in line with research conducted by Dirman (2020); Hasibuan (2021); Muigai & Muriithi (2017) which stated that firm size had a significant positive effect on financial distress.

Based on the results of hypothesis testing, it was known that leverage had a significant negative effect on financial distress. This means that the higher the leverage ratio of a company, it can result in a decrease in the company's financial distress. This can occur because of several factors, including the leverage used by the company to measure the condition of the company's ability to pay its long-term obligations (Purnama & Daljono, 2013). The better the company's ability to fulfill its obligations, indicates that the company has sufficient resources to cover debts and the interest that the company itself owes. Therefore, it can be judged that the company is in a healthy condition and does not experience financial distress. This research was in contrast to research conducted by Ananto et al. (2017); Bernardin & Tifani (2019) which stated that leverage had a significant positive effect on financial distress.

Based on the results of hypothesis testing, it was known that the board of directors had no effect on accounting conservatism through financial distress as a mediating variable. These results may imply that the number of boards of directors of a company has no effect on financial distress and does not affect the application of accounting conservatism in the company itself. These results were not in line with agency theory which states that the board of directors is one of the components of good corporate governance which is responsible for managing all company affairs, including the company's own finances.

The results of this study were due to several factors including the proxies used to

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measure the board of directors itself. In this study, the board of directors was proxied by the number of company boards of directors. The number of members of the board of directors did not reflect the quality and effectiveness of the performance of the board of directors in making company decisions, both in the management of company finances and in the decision to consider the application of accounting conservatism in corporate financial reporting. Therefore, the board of directors had no effect on accounting conservatism through financial distress.

Based on the results of hypothesis testing, it was known that firm size had a significant positive effect on accounting conservatism through financial distress as a mediating variable. These results can be interpreted that the larger the size of the company can increase the company's financial distress and cause the application of accounting conservatism to increase. This is because the larger the size of a company will result in higher political costs imposed on the company. The existence of higher political costs will have an impact on the company's profits, it tends to be lower, if this happens continuously the company will experience financial distress.

Low profits in companies in financial distress conditions will be a signal for management to be more careful in managing company finances, and to immediately prepare efforts that might be made to overcome this, where one of the efforts that can be done is to implement accounting conservatism on financial reporting. This is because the principle of accounting conservatism itself is considered to be the most rational guide in overcoming the difficult conditions of the company, besides that the application of accounting conservatism in financial reporting can provide a positive signal to external parties that the company has presented accurate and quality financial reports.

Based on the results of hypothesis testing, it was known that leverage had a significant negative effect on accounting conservatism through financial distress as a mediating variable. This may imply that the higher the leverage ratio, the lower the company's financial distress experienced by a company, and a decrease in the application of accounting conservatism. This can occur because of several factors, including the leverage used by the company to measure the condition of the company's ability to pay its long-term obligations (Purnama & Daljono, 2013). The better company's ability to fulfill its obligations indicates that the company is in a healthy condition and suppresses the company's financial distress. This is because the company has assets that are able to cover debts and interest which are the company's obligations.

The decreasing financial distress condition resulted in a decrease in the application of corporate accounting conservatism. This can occur because the company is in a stable condition and gives rise to opportunistic actions by company management to maximize possible profits by immediately recognizing profits, assets and other benefits that will be received by the company. These efforts can result in increased company profit, so that the benefits received by management will increase. Therefore, leverage had a negative effect on accounting conservatism through financial distress as a mediating variable.

## CONCLUSION

The conclusion of this study was that financial distress was a partial mediation because it was unable to mediate the effect of all independent variables on the dependent variable in this study. Based on the results of the hypothesis test, financial distress only mediated the effect of firm size and leverage on accounting conservatism, but was unable to mediate the effect of the board of directors on accounting conservatism. Based on this research, it is hoped that the company will be able to increase the application of accounting conservatism in order to produce quality financial reports and avoid any negative impacts that may arise in the future. The limitation of this study is that the research sample is limited to manufacturing companies, and does not yet distinguish between companies experiencing financial difficulties and those not. In addition, accounting standard policies are more dominant to apply the concept of fair value, so that the application of the principle of conservatism is limited in practice. Suggestions for further research are to measure the variable of the board of directors based on the characteristics of the board of directors to better reflect the quality and effectiveness of the performance of the company's board of directors in making corporate decisions, especially in terms of the application of corporate accounting conservatism.

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