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THE FACTORS AFFECTING ACCOUNTING CONSERVATISM IN LISTED INDONESIAN MANUFACTURING COMPANIES

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Abstract

This study analyses the factors affecting accounting conservatism. The factors included in this study are bonus plan, debt covenant, growth opportunity, and litigation risk. The sample is manufacturing companies listed on the Indonesian Stock Exchange that published an audited financial report for the 2013-2015 period. The 156 points of data were collected based on purposive sampling from 52 manufacturing companies in Indonesia and were analysed using multiple linear regressions. The study concluded that debt covenant has a positive effect on accounting conservatism, growth opportunity has a positive effect on accounting conservatism, bonus plan has no effect on accounting conservatism, and litigation risk has no effect on accounting conservatism.

INTRODUCTION

Uncertain future economic conditions encourage companies to maintain the trust of external parties and to convince them of the health of their company. Internal parties (managers) use financial statements as a tool to communicate the health of the company to external parties. Financial statements are a form of management accountability for managing corporate resources based on which users make economic decisions.

Based on the International Financial Reporting Standards (IFRS) and Indonesia financial accounting standard (SAK) (IAI, 2017), the purpose of financial statements is to provide information related to the financial position, performance, and changes in the financial position of an entity that is beneficial to users in economic decision-making. The financial statements will be more useful if they meet qualitative characteristics that are relevant, faithfully represented, comparable, verifiable, timely, and understandable.

Such statements promise better decision-making that avoids misleading and harming external parties.

The financial statements are the records of the company's financial information in an accounting period that can be used to describe the company's performance. In preparing financial statements, SAK provides managerial flexibility to choose the accounting methods to prepare financial statements. This flexibility will affect the behaviour of managers in each company to perform accounting tasks and report financial transactions following the needs and desires of the company. Therefore, to maintain financial statements that describe the actual condition of the company and not tend to be optimistic in its presentation, the concept of conservatism is born.

Accounting conservatism is defined as a cautious principle in recognising transactions subject to economic uncertainty. The principle of conservatism accelerates the recognition of economic losses and delays the recognition of economic benefits. Conservatism is an accounting principle which, if applied, will result in profits and assets that tend to be understated, as well as cost and debt numbers that tend to be overstated. In line with accounting conservatism, when a company is choosing two or more alternative accounting methods with the same ability to produce objective financial statements, the company will select alternatives with the most unfavourable impact. The application of accounting conservatism will generate the lowest profit that can be anticipated by the company so that it can estimate its earnings in the future. That way the company can determine the sustainability of its business in the future.

Bonus plans are proxied by the managerial ownership structure and are linked to management actions in choosing accounting methods that will maximise profits to earn bonuses in the form of ownership of shares to the management. With the ownership of shares by management, the management can determine the level of conservatism that will be applied by the company. Oktomegah (2012) states the selection of conservative methods in companies whose ownership structure is concentrated in particular individuals, especially managers, will be more likely to maximise compensation so that earnings management will increase.

Debt covenants are agreements to protect lenders from the actions of managers against the interests of creditors such as dividing excessive dividends or leaving the equity below the prescribed level (Harahap, 2012). Debt covenant hypothesis predicts that managers want to increase profits and assets to reduce the cost of renegotiating debt contracts. Managers of companies that perform credit agreements will tend to choose accounting methods that will maximise profits so that external parties do not have a negative view toward the company. Based on research conducted by Risdiyani and Kusmuriyanto (2015), leverage has a positive influence on accounting conservatism whereby means increased leverage will improve the application of accounting conservatism. As the debt grows, managers will be more careful to reduce risk leading managers to apply conservative accounting.

Growth opportunity is the opportunities for companies to invest in profitable things. Companies with high growth opportunities tend to require funds large enough to finance its growth in the future. If the company has a

good growth rate, it will have a ratio of market to book value of equity which is higher than companies that do not have a growth opportunity (Harahap, 2012). Verawaty, Merina & Yani (2015) concluded that the growth opportunity has a positive effect on accounting conservatism. Given the opportunity to grow, the funds needed to make investments will undoubtedly increase. This encourages companies to be more careful so that the company can cover all costs incurred by the investment without disrupting the operations of the company.

The risk of litigation is defined as an inherent risk to the company that allows for the threat of litigation by the party who feels aggrieved by the company. The manager's policy in reporting their finances depends on the legal environment applicable to an area where the company is located. The existence of regulations and law enforcement in an accounting environment will require managers to more closely look at accounting practices to avoid the threat of legal provisions. The costs incurred due to lawsuits by creditors and shareholders may encourage the implementation of accounting conservatism (Nugroho & Mutmainah, 2012). Dewi, Herawati & Sinarwati (2014) found evidence that the lower ability of firms to pay off their current liabilities can lead to lower solvency ratios, thus causing risks for companies to be subject to lawsuits. Managers will seek to report less conservative finances to achieve their interests in the short-term.

Research on the factors affecting accounting conservatism generated different results. Based on the above issues, it is necessary to research the factors affecting accounting conservatism because investment decision makers will need more information, not only from information written in the financial statement, but also the information implied from the selected accounting methods. This research focuses on whether a bonus plan, debt covenant, growth opportunity, and litigation risk partially affect accounting conservatism.

LITERATURE REVIEW

Agency Theory

Agency theory describes a relationship between the shareholders (owners) as the principals and the managers as the agents. The shareholder is a party that delegates the authority to manage the company to the management, and management as an agent is a party contracted by shareholders to work in the interests of shareholders and be responsible for all its work to shareholders (principals). Jensen & Meckling (1976) described the agency relationship as a contract between one or more people (principals) that involves another person (agent) performing a service on behalf of the principal who authorises the agent to make the best decision for the principal. The agency theory assumes that every individual acts on their behalf. Investors or shareholders have an interest in increasing their investment in the company in the form of capital gains and getting a return on investment in the form of dividends. While the management must be able to meet the interests of shareholders, they also have an interest in getting bonuses or high incentives from shareholders.

Shareholders can evaluate the performance of managers from the profits generated by the company and the dividends distributed. The higher the profit earned, the manager has performed well and deserves high incentives. If the

principal does not supervise the activities carried out by the agent properly, then the activities by the agent may violate the rules and harm the company in the future because the agent has decision-making authority. There are two mechanisms to reduce the agency problem, namely accounting conservatism and managerial ownership (Fendiani & Tandiono, 2016).

Positive Accounting Theory

Positive accounting theory suggests that a manager has an incentive to maximise his or her prosperity (Nugroho & Mutmainah, 2012). Positive accounting theory can be used to view the performance of managers as tending to raise earnings to hide negative performance. According to Watts & Zimmerman (1990), there are three hypotheses in positive accounting theory that can motivate a manager in making earnings management and influence them to make decisions related to the application of conservatism in financial reporting. The hypotheses are (1) bonus plan hypothesis, (2) the debt covenant hypothesis, and (3) political cost hypothesis. Bonus plan hypothesis illustrates the relationship between management and the owner (shareholder). The debt covenant hypothesis describes the relationship between management and creditors, and the political cost hypothesis describes the relationship between management and government.

Accounting Conservatism

Conservatism is a prudent reaction to uncertainty aimed at protecting the rights and interests of shareholders and debt holders that determine a higher standard verification to recognise good news than bad news. With the principle of prudence, it is expected to provide benefits for every user of financial statements so that financial statements can be a tool for investment decision-making (Basu, 1997).

Bonus Plan

Bonus plan hypothesis in positive accounting theory states that managers will act along with the bonus given (Watts & Zimmerman, 1990). Bonuses are awarded when the desired profit target set by the owner of the company is met. Based on the motive to obtain the bonus, the manager will make earnings management by maximising profit so that the target profit is met. Such practices make earnings reporting less conservative and very likely mislead the users of financial statements. Prior research showed that managerial ownership negatively affects accounting conservatism. As managerial ownership reduces, agency issues will arise so demand for conservative reports will increase. This leads to the first hypothesis of this research:

H1: Bonus plan affects accounting conservatism.

Debt Covenant

Debt covenant hypothesis in positive accounting theory predicts that the higher the amount of debt or loan the firm wants to acquire, the more the presentation of financial statements is not conservative (Watts & Zimmerman, 1990). It is because companies want to show a good performance to debt holders, so debt holders believe that the security of the funds is guaranteed. Efforts to convince the debt holders are done by raising the value of assets and profits as high as possible, as well as reduce liability

and expenses. These actions result in less conservative financial statements. Prior research showed that leverage has a positive influence on accounting conservatism, which means increased leverage will increase the application of accounting conservatism. The higher the debt, the more cautious the managers (Risdiyani & Kusmuriyanto, 2015). This leads to the second hypothesis:

H2: Debt covenant affects accounting conservatism.

Growth Opportunity

Growth opportunity refers to the company's opportunity to invest in profitable projects (Wulandari, Andreas & Ilham, 2014). Companies with high growth opportunities will tend to require large amounts of funds to finance future growth. By increasing investment, the company has the opportunity to grow, and the company can have the opportunity to make a profitable investment. Companies that will increase the amount of investment tend to choose accounting conservatism because of the lower earnings calculations (Wulandari et al., 2014). This leads to the third hypothesis:

H3: Growth opportunity affects accounting conservatism.

Litigation Risk

Litigation is a risk faced by the company on the existence of lawsuits from other parties. The risk of litigation as an external factor is based on the view that investors and creditors are those who are legally protected. The company will always avoid litigation or lawsuits because when a company has legal issues, not only will the cost incurred increase but will also harm the value of the company. Dewi et al. (2014) found evidence that the lower the company's ability to pay off its current liabilities can lead to lower solvency ratios. It can cause risks for the company to be subject to lawsuits. Managers will hence seek to report less conservative financial statement to achieve their interests in the short-term. This leads to the fourth hypothesis:

H4: Litigation risk affects accounting conservatism.

MATERIALS AND METHODS

This research adopts a quantitative design using empirical data. This study aims to generate empirical evidence about the effect of independent variables, which are bonus plan, debt covenant, growth opportunity, and litigation risk, on accounting conservatism as the dependent variable. This study uses sample manufacturing companies listed on the Indonesian Stock Exchange (IDX) for the 2013-2015 period.

All data in this research is secondary data. The companies' financial data is taken from their financial statements for 2013-2015 ended on 31 December and audited by independent auditors. The data is subject to multiple regression analysis. Analytical techniques include determining the model of regression equation:

$$\text{CONS} = \alpha + \beta_1 \text{BON} + \beta_2 \text{DC} + \beta_3 \text{GOP} + \beta_4 \text{RLI} + \varepsilon$$

CONS : Accounting Conservatism

BON : Bonus Plan

DC : Debt Covenant

GOP : Growth Opportunity

RLI : Litigation Risk

Dependent variable

Accounting conservatism is a concept that recognises costs and losses faster, recognises revenue and luck more slowly, assesses assets with the lowest value, and liabilities with the highest value. In this study, accounting conservatism is proxied by accrual conservatism or referred to as CONACC. Accrual conservatism of this model is obtained through the division between non-operating accrual and total assets and then multiplied by (-1) (Nasir, Ilham & Yusniati, 2014).

$$\text{CONNAC} = \frac{\text{Non-operating Accrual}}{\text{Total Asset}} \times (-1)$$

Non-operating Accrual = Operating Accrual - Δ Account Receivable - Δ Inventory - Δ Prepaid Expense + Δ Account Payable + Δ Taxes Payable
 Operating Accrual = Net Income + Depreciation - Net Operating Cash Flow
 Net Operating Cash Flow = Difference between cash inflows and cash out of operating activities

Independent Variables

Bonus plan theory describes management actions in choosing accounting methods to maximise profits to earn high bonuses. The bonus plan illustrated through this variable is proxied by managerial ownership structure. Managerial ownership structure is measured by the proportion of share ownership owned by management (directors and commissioners) (Oktomegah, 2012).

$$\text{Bonus plan} = \frac{\text{Numbers of shares of by management}}{\text{Total Shares}}$$

Debt covenant is a contract aimed at borrowers by creditors to limit activities that may damage the value of loans and loan recovery. The leverage ratio is used to assess the company's ability (in this case, an asset) in paying off all its debts (Nugroho & Mutmainah, 2012).

$$\text{Debt Covenant} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Growth opportunity is the company's opportunity to invest in profitable things (Wulandari et al., 2014). Market to book ratio is the ratio of the value per share of common stock over the book value per share of equity.

$$\text{Growth} = \frac{\text{Outstanding Shares} \times \text{Price}}{\text{Total Equity}}$$

Litigation risk is defined as an inherent risk to the company that allows the litigation threat by the parties concerned with the company that feels disadvantaged. The current ratio provides an overview of the company's ability to pay its short-term liabilities by using current assets owned by the company.

$$\text{Litigation} = \frac{\text{Current Liabilities}}{\text{Current Assets}}$$

RESULTS AND DISCUSSIONS

Table 1

Results of Regression Analysis

Variables	Coefficient	t-stat
Constant	-,072	-5,584*
Bonus Plan	-,011	-,319
Debt Covenant	,154	4,135*
Growth Opportunity	,009	4,053*
Litigation Risk	-,013	-,598
Adjusted R Square		20.2%
F test		10,785
Sig		0

*= significant at 0.05 level

The first hypothesis in this study is that the bonus plan affects the application of accounting conservatism. The sig value of 0.751 is higher than the significant value of 0.05, which means that the bonus plan variable has no significant effect on the application of accounting conservatism. Thus, hypothesis (H1) is rejected. There is no significant influence between the bonus plan and the application of accounting conservatism because the amount of stock ownership by managerial parties (directors and commissioners) who manage companies in the manufacturing industry in the Indonesian Stock Exchange from 2013 until 2015 is low. Thus, the management is not able to influence the policy to be applied by the company. The results of this study are in line with Wulandari et al. (2014) that stated that there is no significant influence between the bonus plan and the application of accounting conservatism. This is because of the low share ownership whereby the company is more concerned with the profit that will be obtained and which will be presented in the financial statements for investment purposes. If the company does not have the reserves to increase the investment, the manager will make earnings reports that tend to be optimistic.

The second hypothesis is that debt covenant affects the application of accounting conservatism. The debt covenant variables proxied by leverage have the regression coefficient value of 0.154 (seen from table 1) and is positive. It means that the debt covenant variable has a positive direction. So, it can be concluded that the debt covenant variable has a significant positive effect on the application of accounting conservatism. Thus, the higher the debt covenant value proxied by leverage will increase the application of accounting conservatism. The results of this study are in line with Risdiyani and Kusmuriyanto (2015) that leverage affects the accounting conservatism

and increased leverage will increase the application of accounting conservatism. Leverage demonstrates the company's ability to pay its long-term debt so that corporate managers will choose various considerations to adopt policies related to the debt to be performed. Any interference from outside parties (creditors) associated with the debt given will affect managers to apply conservative accounting to avoid greater higher risk.

The third hypothesis in this study is that growth opportunity affects the application of accounting conservatism. The growth opportunity variable is calculated using MBVE (market to book value of equity) has the value of the regression coefficient of 0.009 (Table 1). This is a positive value which means that the growth opportunity variable has a positive direction. It can be concluded that the growth opportunity variable has a significant positive effect on the application of accounting conservatism. A higher growth opportunity value calculated using MBVE (market to book value of equity) will increase the application of accounting conservatism. The results of this study are in line with Verawaty et al.'s study (2015) which states that growth opportunity has a positive effect on accounting conservatism. It shows that a growing company will apply accounting conservatism to get a positive response from investors so that the market value of the company will be more significant than its book value which will create goodwill.

The fourth hypothesis in this study is that the risk of litigation affects the application of accounting conservatism. The sig value of 0.551 is higher than the significant value 0.05, which means that the litigation risk variable has no significant effect on the application of accounting conservatism. Hence, hypothesis (H4) is rejected. There is no significant influence between the risk of litigation and the application of accounting conservatism because Indonesian law does not threaten the survival of the company so that the company does not consider the possibility of litigation experienced by the company from 2013 to 2015. Weak legal forces in Indonesia cause companies not to consider the threat of lawsuits as one factor that they should be more careful in accounting records (Agustina, Rice & Stephen, 2016). The results of this study are in line with the research conducted by Juanda (2007) and Agustina et al. (2016) which stated that litigation does not affect the application of accounting conservatism. The weak law enforcement in Indonesia resulted in the weak anticipation of managers against litigation risks.

CONCLUSIONS

Based on the analysis and discussion, the factors that affect the application of conservatism are the debt covenant and growth opportunity, and the factors that do not affect the application of conservatism are bonus plan and litigation risk. The bonus plan does not affect the application of accounting conservatism. Based on the results of this study, it means the amount of ownership by the managerial board of directors and commissioners who manage companies in the manufacturing industry listed in the Indonesian Stock Exchange from 2013 until 2015 is low so that management is not able to influence the policy to be applied in a company. Based on the results of this research, debt covenant has a positive and significant influence on the application of accounting conservatism. It means that the higher the debt covenant value proxied by leverage will increase the application of

accounting conservatism. This causes the company managers to be more cautious in choosing policies related to debt to reduce termination contract debt and attract investor confidence. Growth opportunity has a positive and significant impact on the application of accounting conservatism. This means that a higher the value of growth opportunity will increase the application of accounting conservatism and attract more investors to invest in the company. Therefore, a company will be more careful in choosing accounting policies. The risk of litigation does not affect the application of accounting conservatism. It means that Indonesian law does not threaten the survival of the company, so the company is not too concerned about the possibility of litigation. Thus, companies do not consider the threat of lawsuits in accounting conservatism.

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