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An Exploration of Accounting Conservatism Practise: Empirical Evidence from Developing Country

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Abstract
This study explores the practice of accounting conservatism in developing countries that have recently adopted IFRS gradually since 2012. The aims of this study were to explore the practices of accounting conservatism in Indonesian company and to investigate the influence of debt covenant and litigation risk toward accounting conservatism. This study employed 90 manufacturing companies in Indonesian Stock Exchange during the period of 2013-2016. The data was analyzed by using a panel data regression with fixed effect model. Based on deskreptif statistical test, showed that 81% company in this study choose to apply the principle of non-moderate conservatism in recognizing income and expenses. It implies that accounting conservatism in Indonesia tends to be low, but it was increase gradualy. The result of this research reveals that debt covenant which is measured by leverage has no effect on accounting conservatism. On the other side, litigation risk which measured by litigation index has positive effect on accounting conservatism. The high litigation risks facing by Indonesian listed companies have been increased the prudential of reporting their financial information to the market.
Keywords: Debt Covenant, Litigation Risk, Accounting Conservatism.

1. Introduction

Indonesian listed company should prepare their financial statements based on the Standards established by the Indonesian Institute of Accountants. Indonesian Financial Accounting Standards provide flexibility in choosing accounting methods that can be used. Various alternative methods of accounting will affect the management in the recording and reporting of corporate financial transactions (Wardhani, 2008). Uncertain future economic conditions may encourage management to implement prudential principles in reporting financial information. In financial terms, this prudential principle is called accounting conservatism. Accounting conservatism is defined as "anticipate to recognize no profit but anticipate all losses" (Bliss, 1924); or "very poor way of treating the existence of uncertainty in valuation and income (Hendriksen, 1982), or "stated earnings that require higher verification to distinguish good news as gains than to recognize bad news as losses" (Basu, 1997), "a preference for a cautious technique in term of financial reporting" (Yunos et al, 2012). The conservatism principle is cautious manner in facing the uncertainty risks, accounting will establish accounting principles based on the most unfortunate circumstances, hopes and results. Ahmed and Duellman (2007) conclude that the conservatism in reporting of company financial lead to reduce agency cost. Moreover Chi et, al. (2009) formulate a hyphotesis that the poor corporate governance may produce an increase the demand of accounting conservatism in preparing financial statements. Governance structure and earning quality have a positive assosiation, a stonger corporate governance creates a greater demand of earning quality.

Some differences views related to the use of the principles of accounting conservatism. Implementation of excessive conservatism will result in financial statements being biased so it can not serve as a tool to evaluate corporate risk (Penman and Zhang, 2002; Sen, 2005). Moreover, "more conservative may cause distortion of accounting data" (Hendriksen, 1982), we argue too conservative financial statements are unable to show actual circumstances because profit becomes an understatement in the current period. In contrast to Watts' (2003) view that conservatism plays an important role in reducing agency costs and improving the quality of financial statement information and ultimately will increase stock prices and firm value. In addition, conservatism plays an important role to offset the excessive optimism of managers and owners, if high earnings assessments tend to be harmful rather than lower earnings assessments (Hendriksen and Breda, 2002). This implies that the consequences of bankruptcy are more serious than profit. Other researchers say that conservatism may also reduce the information asymmetry that occurs between shareholders and managers and creditors. Shareholders require managers to preach bad news so that they will further minimize potential losses by increasing supervision or replacing managers with personal interests (Li, 2015).

Some positive views about the benefits of accounting conservatism prove that conservatism plays an important role in anticipating unstable financial conditions by delaying the recognition of income and accelerating the recognition of losses. However, in reality there are some companies that do not be prudent in the present of its financial statements to become overstatement. Excessively overstatement is more dangerous than understatement because the risk of claims will be greater when presenting financial statements with a higher profit than the real.

Chi, et al. (2009) confirms it is regarded as an efficient way to address the moral hazard problem arising from the asymmetric information between interested stakeholders.

Research on accounting conservatism has been done by previous researchers, but the results on the factors that affect accounting conservatism are still not consistent. Bandi and Shintawati (2014) also prove that board characteristics are measured by the proportion of independent board of commissioners, board size and number of board meetings and debt covenant affects accounting conservatism. Wulandini and Zulaikha (2012) state that the characteristics of the board of commissioners measured by size and independence have no effect on accounting conservatism.

Oktomegah (2012) showed that debt covenant and political costs have an effect on accounting conservatism in manufacturing companies. Nugroho and Mutmainah (2012) found that the risk of litigation and financial difficulties had an effect on accounting conservatism, but managerial and debt covenant ownership had no effect on accounting conservatism. While Nikolaev (2010) showed a significant positive influence on contract debt to accounting conservatism. Juanda (2007) examined the effect of litigation risk on accounting conservatism, the results of the study stated that litigation risk has a negative effect on accounting conservatism.

Research on accounting conservatism has also been done in many countries. Research conducted by Boussaid et al. (2015) on the corporate board and its effect on accounting conservatism on industrial companies in France. The results show that board size, gender diversity, board meeting, and board attendance have a significant effect on accounting conservatism. While board independence and board leadership have no effect on conservatism. Furthermore, Yunos et al. (2014) also conduct research that employs independent variables of board characteristics including proportion of independent directors, proportion of financial expertise on the board, and board size. The statistical test of the study proves that independent board, financial expertise board has a significant positive effect on conservatism. While board size does not affect the accounting conservatism of non-financial companies listed on the Malaysia Stock Exchange.

Although many studies have been conducted in various countries, there are still inconsistencies in the result. Therefore, this study will examine the factors that may affect accounting conservatism specifically debt covenant and litigation risk. The purpose of this study is to examine and analyze the effect of debt covenant and litigation risk on accounting conservatism based on positive accounting theory and agency theory. This study explores the practice of accounting conservatism in developing countries that have recently adopted IFRS gradually since 2012, thus the results expected makes important contributions to existing literature.

The rest of the paper is structured as follows. The next section followed by a literature review and development of hypotheses. The study data and research methodology are then discussed. The penultimate section discusses the empirical results. The final section presents the summary and conclusion.

2. Literature Review and Hypotheses Development

Positive accounting theory explains and predicts the reasons for accounting procedures selection by management. Watts and Zimmerman (1986) stated that there are three hypotheses which affect management choices whether optimistic or conservative accounting procedure, there are (1) bonus plan hypothesis, (2) debt covenant hypothesis, and (3) political cost hypothesis. Bonus plan hypothesis states that bonus/reward motivation will drive the managers to report higher earnings, the management will be more expectant on profit when bonus becomes the determinant to calculate their compensation. Furthermore, debt covenant hypothesis predicts that managers want to increase profits and assets to improve leverage ratios in order to minimize the risk of debt contract violate. Furthermore, the political cost hypothesis states that large firms are more sensitive than small firms because of political costs, and therefore the companies face different situation in choosing accounting method.

This study goes in the perspective of agency theory that beliefs that agency conflict occurred because of conflict of interest between management as agent and shareholder as principal (Jensen & Meckling, 1976). To reduce agency conflict, the company needs to consider conservatism accounting policy. Moreover, conservatism is beneficial for Board of Director (especially those external directors) in executing their duties as a decision maker and monitor the management. Lafond and Roychowdhury (2008) stated that conservatism may overcome agency conflict when ownership and control are separated. In order to defend existence, the management tend the corporation avoid the litigation risk and be more conservative in choosing accounting methods to prevent the threat of lawsuits.

2.1 The Effect of Debt Covenant on Accounting Conservatism

Debt covenant is restriction imposed by the creditor during the term of the debt contract. Debt covenant interpreted as an agreement to protect a creditor from the management opportunistic and moral hazard based on Watts (2003) argument, managers expected not to pay attention on the interests of creditors such as dividing excessive dividends or allowing equity under the minimum standard. Positive accounting theory explains debt covenant hypothesis which assumes when leverage ratio is high, management will choose accounting procedure that can modify income reporting of next period to the current period (Januarti, 2004). By selecting the apropriate accounting method to recognize income of next period to the current period, a company will have lower leverage which ultimately reduces violation of debt covenant. Emperical evidence has presented in several litterateurs (see Ahmed et al., 2002; Brown et al., 2006; Kim and Kross, 2005; LaFond and Watts, 2008; Lin, 2006; Zhang, 2008) that less conservatism lead to increase the value relevance of earnings, bring to lower earnings management, fewer asymmetric information and cheap cost of debts.

Previous researchers also pay their attention to the effect of debt covenant to accounting conservatism, such as Noviantari and Ratnadi (2015) and Oktomegah (2012) who found that leverage has the significant and negative effect on conservatism. Consecuently, the following hypothesis states that:

H_1: Stricly debt covenant drive the less accounting conservatism practice

2.2 The Effect of Litigation Risk on Accounting Conservatism

Zmijewski and Hagerman (1981) hypothesize that political costs vary against corporate risk, and high-risk firms are more likely to choose portfolio procedures that degrade earnings. Litigation risk is defined as firm risk which may create litigation threat by stakeholder and harm the company. The potential risk of litigation is triggered by an inherent risk to the firm in relation to non-compliance with the interests of investors and creditors (Qiang, 2003). The risk of litigation may arise from the creditor or investor. Agency theory states that management as the agent is mainly obliged to maximalize stakeholder interest. When management does not careful in reporting financial of the company, may harm stakeholder and law claim. Companies clissified in a high-risk litigation industries prefer adopt conservative report to reduce the risk of litigation and costs (Xu and Lu, 2008). When a corporation faces a legal case, the company will cost a lot, even can cause the threat of bankruptcy. Litigation produces asymmetric rewards in exaggerating the company's net assets that are more likely to generate litigation costs for the firm.

There is legal regulation in accounting which demands the managers be more careful the *demand* for conservative accounting comes from the contracting role of accounting.in choosing accounting method. Given this condition, managers are expected to maintain estimated litigation expense and gain by using conservative accounting. Previous researchers conducted by Ningsih (2013) and Deslatu and Susanto (2009) found that there is positive and significant impact of litigation risk and accounting conservatism. On the views of agency arguments, the following hypothesis state that:

H_2: Litigation risk has positive effect on accounting conservatism

3. Research Method

This is quantitative study to explore the level of conservatism practice of Indonesian company and to show emperical evidence the effect of debt covnant and litigation risk toward accounting conservatism. The sample of this study is 90 manufacturing companies listed in Indonesia Stock Exchange during the period of 2013-2016 and totally 360 firm-year observations. Our research exlude companies do not publish annual repot consistently as long research time. Firms that do not have sufficient data for each variable also drawn from the sample.

Table 1 below explains operational definition of our variables and measurement of each variables.

Table 1. Operational Definition of Variable

Variable	Operational Definition	Measurement
Accounting Conservatism	Accounting principle which recognizes possible costs or losses that will occur but does not immediately recognize future income or profits (Suwardjono, 2010).	$\mathbf{CONS} = \frac{\boldsymbol{NI + Depr - CFO}}{\boldsymbol{TA}}\boldsymbol{X - 1}$ NI = net income before extraordinary items Depr = Depreciation CFO = operating cash flow TA = Total asset (Modified from Givoly & Hayn, 2000; Wardhani, 2008)
Debt Covenant	Agreement of company and creditor which mention particular financial ratio limit that should be maintained by company (Hardy and Ahalik, 2015).	$\mathbf{DEBT} = \frac{\text{long debt}}{\text{total asset}}$ (Hardy and Ahalik, 2015; Nugroho & Mutmainah, 2012)
Litigation risk	Risk of threat by stakeholder which may harm the company (Juanda, 2007).	**LITI** = LIK + LEV + SIZE $\textbf{Liquidity}\ (\boldsymbol{LIK}) = \frac{\text{current liabilities}}{\text{current asset}}$ $\textbf{Leverage}\ (\boldsymbol{LEV}) = \frac{\text{long term liabilities}}{\text{total asset}}$ $\textbf{Firm size}\ (\textbf{SIZE}) = \text{log natural of total asset}$ (Fatmariani, 2013)

The model proposed in this paper is:

$$\mathbf{CONS_{it} = \beta_{0it} + \beta_1\, DEBT_{it} + \beta_2\, LITI_{it}\, (LIK_{it} + LEV_{it} + SIZE_{it}) + \varepsilon_{it}}$$

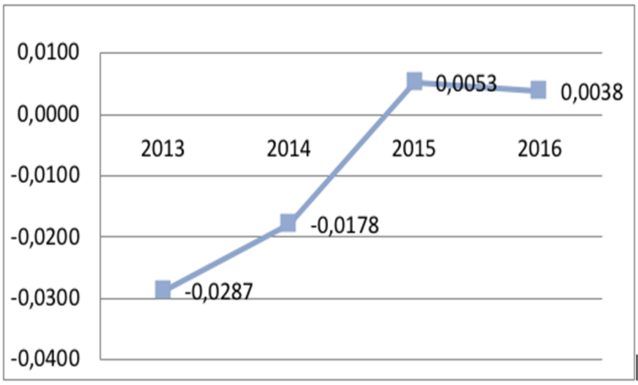
Where $CONS_{it}$ denoted conservatism practice for firm *i* in year *t,* $DEBT_{it}$ denoted the level of debt covenant facing by each firm ($_i$) in year *t*, $LITI_{it}$ denoted litigation risk that a total number from liquidity ratio plus leverage ratio and firm size for firm *i* in year *t*. ε_{it} is the error term.

Data is collected by documentation method of secondary data from financial statement and annual report of manufacturing companies. In addition, data is analyzed by descriptive statistic analysis and inferential statistic analysis of panel data regression. Panel data regression allow explicit individual heterogeneity and is proper for study of dynamic adjustment (Gujarati, 2013). The data passed test of normality, multicoliniarity and heteroscedastisity. For robustness we employed 3 model, they are pooled least square/ common effect, fixed effect and random effect. Panel regression mensyaratkan to choose the best estimate empirical model from three model, using Chow test and Hausman test, the best model from this data is fixed effect model.

4. Results and Discussion

4.1 The Accounting Conservatism Practise in Indonesia

Grafik 1 discribe the accounting conservatism practise in manufacturing company during 2013 – 2016. Conservatism was measured using modified formula from Givoly & Hayn (2000) and Wardhani (2008). The calculated index means that the greater the value (positive number) means the company anticipate to recognize profit and immediately recognize the loss. Grafik 1 showed the development of conservatism behavior tends to be conservative in their financial reports from being more aggressive in the previous year.



Picture 1. The Conservatism Pactice in Indonesia 2013 – 2016

4.2 Descriptive Statistics Test of Variables

Based on the Table 2 above it is concluded that mean of accounting conservatism is -0,0093, means manufacturing companies during 2013-2016 preffer an agresive accounting principle to report company performance. Moreover, debt covenant has mean of 0,5374, indicates that manufacturing companies have assets paid by liabilities as much as 53,74 %. The values show that leverage is considered low which direct to debt covenant potential of violation is also lower. Furthermore, litigation risk has mean of 29,3597 which demonstrates that litigation risk of manufacturing companies tend to be low due to firm ability to maintain its reputation for lawsuits.

Table 2. Descriptive Statistic

Variable	**n**	**Min**	**Max**	**Mean**	**Std. Dev**
Accounting Conservatism	360	-0,2714	0,5452	-0,0093	0,0725
Debt Covenant	360	0,0662	5,0561	0,5374	0,5376
Litigation Risk	360	25,5236	38,4180	29,3597	1,8966

4.3 Hypothesis Testing

This study state two hiphotesis, debt covenant and litigation risk asociate with conservatism in accounting. However, before use the best model to make a prediction, three model specification tests was conducted (Common Effect, Fixed Effect, and Random Effect). Based on the result of chow test and hausman test, fixed effect model is found to be the best model for this study.

The result of hypothesis testing is demonstrated in Table 3 below:

Table 3. Hypothesis Testing

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constanta	-2.253466	0.404308	-5.573633	0.0000
DEBT_COVENANT	-0.023140	0.033172	-0.697570	0.4861
RISK_LITIGASION	0.076859	0.014160	5.427872	**0.0000***
	Effects Specification			
Cross-section fixed (dummy variables)				
R-squared	0.417841	Mean dependent var		-0.009337
Adjusted R-squared	0.220167	S.D. dependent var		0.072546
S.E. of regression	0.064064	Akaike info criterion		-2.441869
Sum squared resid	1.099931	Schwarz criterion		-1.448753
Log likelihood	531.5364	Hannan-Quinn criter.		-2.046987
F-statistic	2.113793	Durbin-Watson stat		2.730055
Prob(F-statistic)	0.000002*			

Note: *) Significant at alfa 1%

Based on the panel regression output above, the regression equation can be constructed as follows:

Accounting Conservatism = -2.25 - 0.02 DEBT_COVENANT + 0.08 RISK_LITIGASION + Ɛ

	Hypothesis	Coefficient	P Values	Result
H_1	Debt covenant has negative effect on accounting conservatism	0,0113	0,7336	Rejected H_1
H_2	Litigation risk has positive effect on accounting conservatism	0,0692	0,0000	Accepted H_1

4.4 Discussion

The Effect of Debt Covenant on Accounting Conservatism

Results indicate that debt covenant does not affect accounting conservatism. Thus, whether company obey debt contract or not does not give any impact on accounting conservatism policy. This study fails to find evidence of positive accounting theory framework that explains if the company may reduce its accounting conservatism practice when the company moves near debt contract violation limit.

Generally, debt contract requires debitor to maintain its financial ratio, such as leverage. When the contract is harmed, creditor will give penalty to the company. For instance by giving constraint in debt addition or dividend distribution. Debt covenant hypothesis describes that managers are motivated to make decision of financial reporting that reduce possible violation of debt contract. This encouragement is different according to consequence expenses in violation of debt contract (Smith and Warner, 1979). Therefore, to avoid those expenses, management tends to choose non-conservative accounting. Meanwhile, this study fails to explain positive accounting theory, which states that when a company is closer to violation limit on debt contract, managers mat reduce its accounting conservatism practice. In addition, this study supports that company has low leverage ratio but low accounting conservatism. Based on the result, more than 90% unit of analysis has leverage in low category. This condition indicates that company tends to obey regulation within the contract to maintain its leverage ratio under the determined limits.

Sari and Adhariani (2009) stated that debt is not the factor to be considered in applying conservatism accounting practice. Even though firm is getting closer to violation limits of debt contract by its high leverage ration, managers will put their effort to obtain fund from investor and increase its performance. Therefore, a company may improve its profit, reduce leverage and avoid expenses of contract violation. In addition, the higher the ratio, financial risk will be higher too due to firm inability to pay its fixed expenses (Nainggolan and Solikhah, 2016). This condition is similar to the concept of accounting conservatism, which mentions that high risk will increase careful responses within the company.

These results contradict Sari and Adhariani (2009) who found that leverage does not affect accounting conservatism. Nevertheless, this study does not support Oktomegah (2012) who concluded that company with high debt level will have lower conservatism practice.

The Effect of Litigation Risk on Accounting Conservatism

Results indicate that litigation risk has positive and significant effect on accounting conservatism. This study supports agency theory that management is obliged to maintain firm reputation in the contract, either for investor or creditor. Based on the perspective of company, avoiding litigation threat encourages manager to disclose bad information immediately in the financial statement, postpone good news and choose conservative accounting policy (Seetharaman et al., 2005)

Law enforcement and accounting environment in Indonesia support this finding. There are some legal regulation of accounting, such as Law No 8 of 1995, Capital Market Supervisor Council (BAPEPAM) regulation, Government Regulation No. 24 of 1998 about firm financial information, Government Regulation as Subtitution of Law (Perpu) No. 1 of 1998 which regulates Law of Brankuptcy (Juanda, 2007). In high enforced regulation, managers tend to apply higher accounting conservatism. Similar to Ball et al., (2000) who stated that common law country where investor relies on published report, timely reporting requirement is higher that the code low country which has low legal and regulation consequences of public reporting. This study is in line to research by Nugroho and Mutmainah (2012) who found that litigation risk has significant effect on accounting conservatism. Moreover, in the perspective of stakeholder either investor of creditor, accounting conservatism practice gives more security for them because it may reduce litigation risk by management behavior which may harm the contract.

5. Conclusion and Implications

This paper explores the degree of conservatism in Indonesian manufacture companies. The results describe that management prefer to apply aggressive financial reporting, but it decrease gradually towards conservative reporting. In addition, this study indicates that manufacturing companies in Indonesia have not applied conservatism in their accounting practice, and thus managers are expected to be more cautious in selecting accounting policy to reduce agency conflict within the company. Based on the hypothesis testing, it can be concluded that debt covenant does not affect accounting conservatism. Meanwhile, litigation risk has positive effect on accounting conservatism. Results show that coefficient of determination has value of adjusted R square as much as 41.78%, which describes that 41.78% of accounting conservatism can be explained by debt covenant and litigation risk. However, the remaining of 58.22 % is described by other variables outside research model.

Ahmed and Duellman (2007) argue that accounting coservatism influenced by firm-specific variables and characteristics, this study exclude some control variables ie company size, financial distress, some governance mechanism variable (board size and quality, independent commissionair, ownership, internal and external audit quality, etc). Further research will be better to adopt thus variables in the empirical models.

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