

# The Role of Debt Covenant in Moderating the Effects of Political Cost on Accounting Conservatism

Nur Fatwa Basar  
Accounting Department  
STIE Tri Dharma Nusantara  
Makassar, Indonesia

Andi Hendro  
Management Department  
STIE Tri Dharma Nusantara  
Makassar, Indonesia

**Abstract:- The purpose of this study was to analyze the direct effect of political cost and debt covenant on accounting conservatism. Besides, this study also analyzes the role of debt covenants as a moderator between the effect of political cost on accounting conservatism. The companies that are the samples are companies indexed on the IDX30 other than financial services companies and companies with non-rupiah financial reports. the data used is secondary data from the financial statements of 20 companies listed on the Indonesian stock exchange. data analysis using multiple linear regression and analysis of variance. The results showed that political cost directly affects accounting conservatism positively and significantly, whereas debt covenant does not have a direct significant effect on accounting conservatism. Besides, this study shows the role of debt covenants in strengthening the effect of political costs on accounting conservatism.**

**Keywords:-** *Conservatism Accounting; Political Cost; Debt Covenant.*

## I. INTRODUCTION

The uncertainty of future economic conditions forces companies to apply prudent reporting principles (Jao and Ho, 2019). This principle is known as accounting conservatism, which until recently has been the subject of debate. One of the criticisms is the notion that accounting conservatism is a constraint in financial reporting. The assumption is that if the financial statements are prepared very conservatively, the results will tend to be biased and do not provide a true picture (Indrayati, 2010). The improper disclosure of accounting information by companies will cause perceptual bias by information users such as investors, creditors, government, and the general public so that it will influence the decisions to be taken (Praditha, 2020).

Penman and Zhang (2000) add that accounting conservatism will cause the quality of company earnings to be lower. However, some parties consider that the application of the principle of conservatism can provide more reliable financial statements because, in its application, this principle reveals the value of losses that the company accrues. Disclosure of this loss is considered more important than information on the profits obtained by the company because it can provide an overview of the risks that

institutional investors may face in the future (Dermadi, 2017). Another assumption also states that basically conservatism is applied because company management is pessimistic to balance the optimism of managers. This attitude is considered capable of reducing the tendency to exaggerate in financial reporting because the valuation of overstated earnings is considered to be more andgerous than understated earnings (Hendriksen, 1992).

One of the reasons companies applies accounting conservatism is to avoid political costs (Watss, 2003 and Lasdi, 2009). Political costs can arise due to conflicts of interest that occur between the company and the government. The company aims to make a profit and carry out business development, while the government aims to build state infrastructure for the welfare of the community. In this case, the government becomes a representative of the community who has the authority to transfer wealth from the company to the community in accordance with applicable regulations (Watts and Zimmerman, 1978). So, to achieve the goal, the government will use its authority to obtain revenue from companies, such as obtaining revenue from collecting taxes on companies.

Belkaoui and Karpik (1989) state that firm size is a representation of the political costs incurred by the company. The number of political costs will be in line with the size of the company. The larger the size of a company, it is also assumed that the performance standards and profitability of the company will also be higher, so that company managers tend to apply accounting conservatism, namely by deferring profits from the present period to the future period. However, positive accounting theory also states that in a ceteris paribus condition, a company will carry out high-value reporting when it has a high debt covenant so that the possibility of reducing the application of the principle of accounting conservatism in the company will decrease.

This study has an important objective, namely to examine the role of debt covenants (leverage) in reducing the tendency to apply accounting conservatism in large companies. In addition, this research is expected to be able to educate accountants in choosing accounting principles that are best applied in companies in order to avoid conflicts of interest or the emergence of agency problems that often occur.

## II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

### A. Accounting Conservatism

Conservatism in FASB Statement No. 2 is described as a prudent reaction in the face of uncertainty. This is to ensure that the uncertainties and risks that may occur in a business condition have been adequately considered. Watts (2003) states that conservatism is the difference in the level of verification needed to recognize benefits compared to recognizing losses.

Conservatism as the tendency of an accountant to admit good news as beneficial as opposed to admitting bad news as detrimental. In other words, conservatism can be interpreted as a principle of prudence by companies in recognizing advantages compared to losses. Critics of conservatism state that the principle of accounting conservatism will indeed cause company profits and assets to be low at first. However, in the end, the company's profits and assets will be high in the future.

Watts (2003) states that it is the responsibility of managers to present financial reports to stakeholders such as shareholders, creditors, and the board of commissioners. When presenting financial reports, moral hazard can arise as long as the report is still able to provide information to investors about managerial performance. This is because the information will influence investors' decisions in determining the investment to be made and can affect the welfare of managers. This then motivates managers to include bias and noise in the financial statements. Conservatism is also able to limit the opportunistic behavior of managers such as creating distortions in earnings in financial statements. In addition, accounting conservatism can also limit opportunistic payments to managers and other parties such as shareholders.

### B. Political Cost Hypothesis

Positive Accounting Theory explains that companies that have high political costs will try to minimize their profits. Scott (2000) states that the greater the political costs that must be incurred by the company, the greater the tendency for managers to choose and apply accounting conservatism procedures that reveal lower than actual earnings. Belkaoui and Karpik (1989) say that political costs are often proxied by firm size. Therefore, the political cost hypothesis is often called the size hypothesis. Company size is used as a proxy for political costs based on the assumption that large companies are more sensitive politically so that their political costs will be greater when compared to small companies.

One of the political costs is a tax which is the obligation of every company in almost all countries in the world. Large companies tend to have large profits so that their tax obligations will be even greater. Therefore, to reduce the obligation to pay taxes, companies will try to carry out accounting conservatism by deferring current period profits and acknowledging them in future periods. So, it can be said that the bigger a company is, the more tendency to apply accounting conservatism (Sumiari and Wirama, 2016). Thus, the hypotheses proposed in this study are:

*H1: Political costs have a positive and significant effect on the application of accounting conservatism.*

### C. Debt Covenant Hypothesis

Company funding sources can come from within the company (internal financing) and come from outside the company (external financing). The source of funding from inside the company comes from the owner's capital, while the source of funding from outside the company comes from loans from outside parties, such as banks and other parties. Loans (debt) will provide incentives for owner-managers to take other actions that have the potential to reduce the value of the company, through investment decisions and financing decisions taken (Almilia, 2005). A high level of debt will make the company more careful because it can be a threat to the company's survival. The debt covenant hypothesis can also be called the debt/assets hypothesis because the measurement of the debt agreement hypothesis generally uses the debt to assets ratio. The higher the debt to assets ratio, the lower the application of the company's accounting conservatism, because the financial statements presented tend to be optimistic by revealing more profits and things that can be positive signals for stakeholders.

*H2: Debt Covenant have a negative and significant effect on the application of accounting conservatism.*

Positive Accounting Theory states that in a ceteris paribus situation, companies that have a high leverage ratio will prefer to use accounting procedures that can replace earnings reporting for future periods to the current period. High earnings reporting will show positive company performance. Therefore, even though the company is large but has a high level of leverage (Debt Covenant), the application of accounting conservatism will decrease (Sumiari and Wiratama, 2016). Thus, the hypotheses proposed in this study are:

*H3: Debt Covenant is able to reduce the effect of firm size on the application of accounting conservatism*

**III. RESEARCH METHOD**

*A. Research Design*

The design of this study is a quantitative study using secondary data from company financial reports. The samples used in this study are companies listed on the Indonesia Stock Exchange and indexed by IDX30 (except for financial service companies). The observation period is a 6-year accounting period, namely the 2014-2019 period.

*B. Operational Definition and Variabel Measurement*

The dependent variable (bound) in this study is Accounting Conservatism. Conservatism is an accounting principle that deals with future economic uncertainty by reporting earnings by slowing down revenue recognition and accelerating the recognition of costs (Givoly and Hayn, 2000). The greater the total negative accruals, the more conservative the accounting applied by the company will be. Conversely, the more positive the accrual value of the company indicates that there is optimism in the company's financial statements. Measurement of the conservatism variable refers to the research of Givoly et al. (2010) where researchers divide the value of conservatism by total assets, with the following formula:

$$CONNACC = \frac{NIO - CFO}{TA}$$

CONACC: Earnings conservatism

NIO: Net income before extraordinary items plus depreciation and amortization

CFO: Total net cash flows from operating activities

TA: Total assets

The result of the calculation will be multiplied by negative one (-1) to ensure that a positive value indicates higher conservatism (Jao and Ho, 2019).

The independent variable (free) used in this study is the company's political costs. political costs are proxied as firm size. The size of the company is a representation of the number of political costs that are likely to be borne by the company. The larger the size of the company, the greater the political costs borne by the company. The size of the company in this study uses the value of Total Asset which is legalized in natural form:

$$PC = LnTA$$

PC: Political cost

TA: Total assets

The moderating variable in this study uses the amount of leverage or debt covenant owned by the company. The leverage ratio used is the ratio of debt to total assets owned by the company (Jao and Galung, 2011).

$$DAR = \frac{TD}{TA}$$

DAR : Debt to asset ratio (Debt Covenant)

TD : Total debt

TA : Total assets

*C. Data Analysis Method*

This study uses multiple regression analysis methods, namely an analysis of the relationship between one variable and two or more independent variables. Relationship between Political Cost Variables and Debt Covenant on Accounting Conservatism. The regression equation is as follows:

$$Y = \alpha + \beta_1 X_1 + \epsilon \dots\dots\dots (1)$$

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \epsilon \dots\dots\dots (2)$$

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_1 * X_2 + \epsilon \dots\dots\dots (3)$$

Y : Accounting conservatism

α : constant

β<sub>1</sub>-β<sub>3</sub> : coefficient

X<sub>1</sub> : Political cost

X<sub>2</sub> : Debt covenant

ε : Error

**IV. RESULT AND DISCUSSION**

*A. Data Characteristics*

Data characteristics	Amount
Number of companies indexed	30
Financial services company	(5)
Non-rupiah financial reports	(5)
Companies Sampled	20
Observation period	6
Data used	120

Table 1:- Data used

Table 1 shows that the data used in this study were 120 data obtained from a population of 30 companies. Based on the predetermined criteria, the number of companies that became the sample was 20 companies. The accounting data period used is 6 years.

*B. Statistic Descriptive*

	CONNACC	PC	DAR	PC*DAR
N	120	120	120	120
Mean	0.054	24.073	43.145	1033.999
Std. Deviation	0.721	1.233	16.460	384.429
Minimum	-2.442	21.808	3.600	97.951
Maximum	2.197	27.125	84.000	1965.476

Table 2:- Statistic Descriptive

Based on table 2, it is shown that the mean and standard deviation values for accounting conservatism, political cost, debt covenant, and moderating role are 0,054 and 0,721; 24,073 and 1,233; 43,145 and 16,460; 1033,999 and 384,429 respectively. Meanwhile, the minimum value for accounting conservatism is -2,442 and a maximum of 2,197. The minimum value for the political cost is 21.808

and the maximum is 27.125. For the debt covenant value, the minimum value is 3,600 and the maximum is 84,000. And the moderation relationship has a minimum value of 97,951 and a maximum of 1965,476.

**C. Test of Direct effect**

Hypothesis testing is done by multiple regression tests. The hypothesis is carried out to test the effect of factors such as political costs and debt covenants on the occurrence of accounting conservatism in companies based on some secondary data obtained during the 6 year accounting period. The results of regression testing can be shown in the table below.

R = 0.494	R Square = 0.244	Adjusted R Square = 0,231
F = 18,909		P-Value = 0,000
$\alpha = -6,776$	$\beta_1 = 0,286$	$\beta_2 = -0,001$
t (X <sub>1</sub> ) = 5,908		P-Value = 0,000
t (X <sub>2</sub> ) = -0,275		P-Value = 0,784

Table 3:- Regression Test

Table 3 shows the results of multiple regression testing about the direct effect between variables. Based on the regression results, it is shown that the effect of political cost and debt covenant as independent variables on accounting conservatism as the dependent variable is 23.1%, while the remaining 76.9% is influenced by other factors that are not included in the research model. Besides, the results of the simultaneous test (F-test) show the number 18,909 with a P-value of 0,000, which means that the two independent variables jointly affect the dependent variable positively and significantly.

In the partial test (t-test), the constant value ( $\alpha$ ) is -6.776. Besides, the value of  $\beta_1 = 0,286$ ;  $t (X_1) = 5,908$ ; P-Value = 0,000 < 0,050 is obtained, which means that the political cost variable has a positive and significant effect on accounting conservatism. An increase in the political cost value of Rp. 1.00 will increase accounting conservatism by Rp. 0.286. Thus, the first hypothesis is supported by the results of this study.

On the other hand, variable debt covenant (X<sub>2</sub>) is known to have a negative but insignificant effect on accounting conservatism. This is indicated by the value of  $\beta_2 = -0,001$ ;  $t (X_2) = -0,275$ ; P-Value = 0,784 > 0,050. This result means that a decrease in the value of debt covenants will increase accounting conservatism, but not significantly. Thus it can be concluded that the second hypothesis in the study is not in line with the research results.

**D. Test of Moderating Effect**

In addition to testing the direct effect of debt covenants on accounting conservatism, this study also examines the role of debt covenants as a moderator between political cost and accounting conservatism. Tests were carried out with Analysis of Variance (ANOVA) as in tables 4 and 5 below.

R	R Square	Adjusted R Square	Std. Error	F	Sig.
0,494	0,244	0,237	0,629	38,040	0,000

Table 4:- ANOVA test

Table 4 shows that the significant direct effect of political cost on accounting conservatism is 23.7%. Meanwhile, the effect of political cost on accounting conservatism moderated by debt covenants is 24.2% with a significance value of 0.000 < 5% as shown in Table 5 below.

R	R Square	Adjusted R Square	Std. Error	F	Sig.
0,511	0,262	0,242	0,628	13,694	0,000

Table 5:- ANOVA test (change statistics)

These results indicate a positive change in the value of Adjusted R Square from 0.237 to 0.242 with a p-value of 0.000, which means that debt covenants play a role in strengthening the effect of political cost on accounting conservatism. Thus, increasing the value of the debt covenant actually strengthens the effect of the political cost in affecting accounting conservatism. So that the third hypothesis in this study is refuted.

**E. Discussions**

➤ *The effect of Political Cost on Accounting Conservatism*

The results showed that political cost which is proxied by company size can increase the value of accounting conservatism. Then the larger the size of the company, which means it has high political costs, the company has a tendency to disclose profits conservatively. Watts and Zimmerman (1990) argue that the political cost hypothesis can predict that large companies are more sensitive to political costs. This is related to the encouragement of the government, which is the policymaker in the country concerned, for payment of political fees. So to reduce the payment of these political costs the company conservatively conducts financial reporting.

Scott (2007) also states that if companies face increasing political costs, the more likely managers are to elect accounting procedures that reduce the value of earnings or conservative. This research is in line with Sari and Adhariani (2009); Sumiari and Wirama (2016).

➤ *The effect of Debt Covenant on Accounting Conservatism*

Debt Covenant Hypothesis, in circumstances ceteris paribus a company that has a high leverage ratio are likely to choose accounting procedures that shift reporting future period earnings to the current period, so the leverage ratio will be tends to decrease. To obtain debt, the company must fulfill conditions are given by creditors such as maintaining financial ratios company. If the company cannot meet the requirements given by the creditor, the company will be subject to a penalty or will be hampered in increasing their loans (Sumiari and Wirama, 2016).

Accounts payable will provide an incentive for owner-managers to do other actions that can reduce the value of the company, through investment decisions and funding decisions (Almilia, 2005). A high level of debt will make the company more careful because high levels of debt can be a threat to survival corporate life.

These results are supported by research by Sari and Adhariani (2009). shows that the greater the leverage ratio used to measure debt covenant, the greater also the possibility the company will use procedures that increase reported earnings current period or financial statements are presented tend not to be conservative (optimistic).

#### ➤ *The role of Debt Covenant as Moderator*

The results of the analysis of the role of the debt covenant as a moderating variable for the effect of political cost on accounting conservatism explain that the size of the debt contract agreement will increase accounting conservatism in large companies. In other words, companies that have large political costs and large debt covenants will increase the likelihood of implementing accounting conservatism. Large companies that have large debts tend to be more careful in disclosing financial information (Sumiari and Wirama, 2016).

However, the role of debt covenants is not proven to be a significant factor in strengthening the relationship between political cost and accounting conservatism. These results are in line with the discussion about the causes of debt covenants not significantly affecting the implementation of accounting conservatism directly. The company's debt covenant tends to be low when compared to the implementation of accounting conservatism so that its role, both direct influence, and moderation, does not show significant results.

## V. CONCLUSION, LIMITATION AND SUGGESTION

The results of this study indicate the influence of political cost on the implementation of accounting conservatism in companies. This finding indicates that the bigger a company is, the greater the level of prudence in disclosing financial information, especially concerning earnings announcements. Besides, this study also found that debt covenants did not have a direct significant effect on accounting conservatism or their role as a moderating effect on political cost on accounting conservatism. These findings indicate that the level of debt owed by the company does not affect the company's prudence in disclosing financial information. The results of this study can be taken into consideration for investors in the process of fundamental analysis in which large asset ownership by the company reflects large accounting conservatism.

Apart from the findings in this study, there are several limitations in this study, namely the types of companies being sampled are not from the same industry but based on indexation. Future research is expected to pay more attention to determining sample criteria. Furthermore, the

factors used in this study were only limited to political costs and debt covenants. Thus, future researchers are expected to consider other factors that may have a more significant effect on accounting conservatism.

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