

# THE EFFECT OF *DEBT COVENANT, POLITICAL COST, FINANCIAL DISTRESS,* AND LITIGATION RISK ON ACCOUNTING CONSERVATISM

Izatul Amaliyah<sup>1)</sup>, Dien Noviany Rahmatika<sup>2)</sup>, Budi Susetyo<sup>3)</sup>

Accounting Study Program, Faculty of Economics and Business, Pancasakti Tegal  
University

Email: [izatulamaliyah11@gmail.com](mailto:izatulamaliyah11@gmail.com)<sup>1)</sup>, [diennovi@upstegal.ac.id](mailto:diennovi@upstegal.ac.id)<sup>2)</sup>,  
[budisetyoups@gmail.com](mailto:budisetyoups@gmail.com)<sup>3)</sup>

**ABSTRACT:** *The purpose of this research is to determine the effect of debt covenant, political cost, financial distress and litigation risk on the accounting conservatism in mining companies listed on the Indonesia Stock Exchange in 2016-2022. This type of research is quantitative research with descriptive approach. The population in this study was 78 companies. The sampling technique uses a purposive sampling. This study used multiple linear regression analysis with the SPSS 22 program. The research results show that debt covenants have a negative effect on accounting conservatism with a significance value of  $0.000 < 0.05$ . Political costs have a negative effect on accounting conservatism with a significance value of  $0.000 < 0.05$ . Financial distress has no effect on accounting conservatism with a significance value of  $0.229 > 0.05$ . Litigation risk has no effect on accounting conservatism with a significance value of  $0.305 > 0.05$ .*

**Keywords:** *Debt Covenant, Political Cost, Financial Distress, Litigation Risk and Accounting Conservatism.*

**ABSTRACT:** The purpose of this research is to determine the effect of debt covenant, political cost, financial distress and litigation risk on accounting conservatism in mining companies listed on the Indonesia Stock Exchange in 2016-2022. This type of research is quantitative research with a descriptive approach. The population in this study is 78 companies. The sampling technique uses the *purposive sampling* method. This study uses the multiple linear regression analysis method with the SPSS 22 program. The results show that *debt covenant* has a negative effect on accounting conservatism with a significance value of  $0.000 < 0.05$ . *Political cost* has a negative effect on accounting conservatism with a significance value of  $0.000 < 0.05$ . *Financial distress* had no effect on accounting conservatism with a significance value of  $0.229 > 0.05$ . Litigation risk had no effect on accounting conservatism with a significance value of  $0.305 > 0.05$ .

**Keywords:** *Debt Covenant, Political Cost, Financial Distress, Risk of Litigation and Accounting Conservatism*

## **A. INTRODUCTION**

### **Background of the Problem**

In this era of globalization, corporate competition is increasingly competitive, business transactions cause high challenges faced, so the higher the uncertainty that companies must face. Companies will always be required to be able to manage important functions effectively and efficiently. The company has good financial statements and a strong foundation, which has accounting rules, objectives, and principles in accordance with general standards. One of the financial reporting processes must apply the principle of conservatism, namely prudence in measuring and recognizing the value of income and profit (Suryoningtyas, 2017)

The phenomenon that occurs regarding accounting conservatism towards financial statements, especially fictitious and inaccurate calculations of financial statements, indicates the low application of accounting conservatism principles in the preparation of company financial statements. The mining company PT Timah (Persero) Tbk (TINS) is suspected of providing fictitious financial statements in the first semester of 2015. An example is in *Press Release* PT Timah Tbk's financial statements in the first semester of 2015 which said that the efficiency and strategies that the company has carried out have yielded positive results, but in fact in the first semester of 2015 suffered a loss in operating profit of Rp59 billion (Afrianto, 2016).

There are several factors in determining a manager's decision to use conservative methods or not. The first factor that has an influence on the application of accounting conservatism is *Debt Covenant*. Debt contracts describe how managers respond to debt agreements. Managers in responding to violations of debt agreements that have matured, will try to avoid it by choosing accounting strategies that benefit them (Siska & Suwarno, 2022).

At *political cost* Larger companies are more likely to pay *political cost* which is higher because companies with larger assets report their financial statements to the public faster than small companies because companies with larger assets tend to have more sources of information, more sophisticated accounting staff and information systems, and have strong internal control systems (Rahmatika, 2021).

*Financial distress* It is the appearance of early signs of bankruptcy to the deterioration of a company's financial condition. The company can tell if there are signs *Financial distress* One of them is by looking at the state of profit earned by a company in a certain period (Siska & Suwarno, 2022).

The variable of litigation risk becomes an external factor, so it can encourage managers to report the company's finances more conservatively and the manager's encouragement to apply accounting conservatism will be stronger, if the risk of litigation threats in the company is relatively high. Litigation risk is a risk that has the potential to incur significant costs because it deals with legal issues (Ardi *et al.*, 2019).

## **B. LITERATURE REVIEW**

### **Agency Theory**

According to Jensen & Meckling (1976) put forward the agency theory for the first time and cited through research Iskandar & Sparta (2019) i.e. a contract between one or more people (*principal*) who gives orders to others (*Agent*) to perform services or work on behalf of the principal and authorize the agent to make the best decision for the principal. The principal referred to in this theory is the shareholder while the agent is the company's management.

### **Positive Accounting Theory**

Hery (2017:106) Positive Accounting Theory Has Problem-Solving Characteristics (*problem solving*) which refers to the reality of accounting practice through an economic and behavioral approach that aims to explain accounting practice itself.

### **Accounting Conservatism (Y)**

Accounting conservatism is the prudent measurement of an asset and profit due to the presence of economic activity in the uncertainty reflected in the financial statements to prevent overly optimistic decision-making actions (Suwardjono, 2014:245), (Savitri, 2016:23)and (Sugiyarti & Rina, 2020).

With the following calculation formula (Givolyn & Hayn, 2000):

$$CONACC = \frac{(NIO + DEP - CFO)X(-1)}{TA}$$

### **Debt Covenant(X1)**

*Debt covenant* is a debt contract addressed to a borrower by a creditor to limit activities that may damage the value of the loan and *Recovery Loan* (Iskandar & Sparta, 2019), (Ramadhoni, 2014) and (Siska & Suwarno, 2022).

*Debt covenant* is proxied using *Leverage level Leverage* calculated using the DAR formula (*Debt to Asset Ratio*), i.e. (Jao & Ho, 2019):

$$DAR = \frac{\text{Total Hutang}}{\text{Total Aset}}$$

### ***Political Cost(X2)***

*Political cost* are all fees or wealth transfers that must be borne by the company in accordance with applicable regulations related to regulations, government subsidies, tax rates and so on (Savitri, 2016:90), (Savitri & Priantinah, 2019) and (Iskandar & Sparta, 2019).

*Political cost* proxied with the size of the company, *SIZE* (company size) is measured by the following formula (Wiecandy & Khairunnisa, 2020):

$$Size = \ln(\text{Total Assets})$$

### ***Financial Distress(X3)***

*Financial distress* is a stage of deterioration in the state of a company that faces financial difficulties for a while as an early warning that can lead to an inability to adequately pay its obligations and even be threatened with bankruptcy or liquidity if it is continuously unable to overcome the completion of its obligations at maturity for a gradually long period of time (Abidin, 2022:62), (Hery, 2016:33) and (Platt & Platt, 2002)

*Financial distress* in this study adopts the Altman *Z-score* (1968) is as follows (Siska & Suwarno, 2022):

$$Z = 1.2X1 + 1.4X2 + 3.3X3 + 0.6X4 + 1.0X5$$

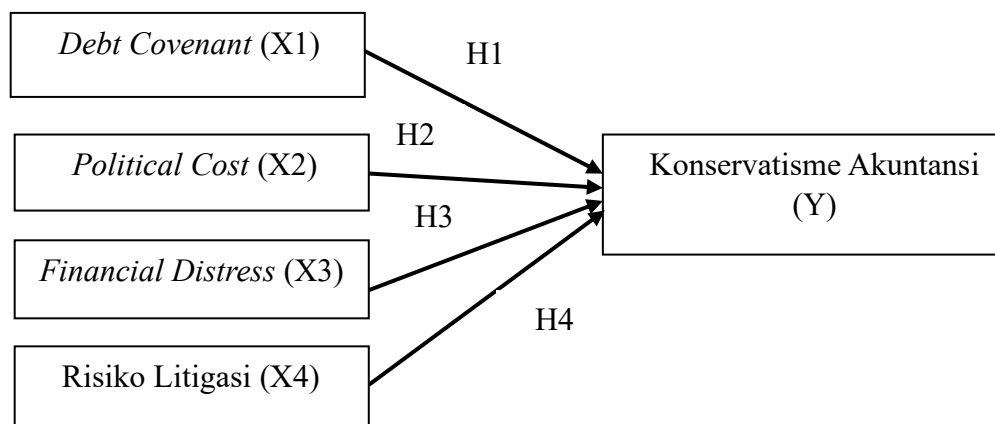
### ***Risk of Litigation (x4)***

Litigation risk is one of the potential risks that converge in the company and is related to legal affairs for claims for losses as a protection measure (Saliman, 2014:268) and (Ardi *et al.*, 2019).

Litigation risk is measured using the ratio *Debt to Equity* Formula *Debt to Equity Ratio* as follows (Nugroho & Mutmainah, 2012):

$$DER = \frac{\text{Total Debt}}{\text{Total Equity}}$$

### Hypothesis



**Figure 1. Framework of Thought**

Hypothetical da peneresearchain ini a.:

- H1 : X1 has a negative influence on Y
- H2 : X2 has a positive influence on Y
- H3 : X3 has a negative influence on Y
- H4 : X4 has a positive influence on Y

### C. RESEARCH METHODS

In the preparation of this thesis, the type of research used is quantitative descriptive, a statistical analysis method with the support of SPSS software, which aims to draw conclusions from the results of the research. The population of this study is all mining companies listed on the Indonesia Stock Exchange (IDX) with a total of 76 mining companies. Sampling using *the purposive sampling technique*, samples of 48 companies were obtained, so that a total of 336 data were obtained that will be used as observation. The data collection method uses a literature study method with a secondary

type of data, namely looking at the financial statements of mining companies for 2016-2022 through the official website of the Indonesia Stock Exchange (IDX).

## D. RESEARCH RESULTS AND DISCUSSION

### Research Results

#### Descriptive Statistical Test

**Table 1. Descriptive Statistical Test Results**

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
Debt Covenant	140	1,01	2,42	1,5600	,27325
Political Cost	140	12,70	27,78	20,1663	3,18357
Financial Distress	140	1,04	71,32	3,2154	6,29688
Risk of Litigation	140	1,01	162,19	5,0431	14,32540
Accounting Conservatism	140	16,00	18,93	17,4975	,87445
Valid N (listwise)	140				

Source: Data processed by SPSS 22

The number of data (N) used during the 7 years 2016-2022 amounted to 336 data. Because of the data transformation on the Y variable, the data used amounted to 140 data. Therefore, the descriptive statistical analysis in this study is as follows:

- The first independent variable is *debt covenant* with a *minimum* and *maximum* value of 1.01 and 2.42 as well as a *mean* and *Std. Deviation* of 1.5600 and 0.27325.
- The second independent variable is *political cost* having a *minimum* and *maximum* value of 12.70 and 27.78 as well as *mean* and *Std. Deviation* of 20.1663 and 3.18357.
- The third independent variable is *financial distress* which has a *minimum* and *maximum* value of 1.04 and 71.32 and a *mean* value of *Std. Deviation* of 3.2154 and 6.29688.
- The fourth independent variable is *litigation risk* having a *minimum* and *maximum* value of 1.01 and 162.19 as well as *mean* and *Std. Deviation* of 5.0431 and 14.32540.
- The results of the analysis on the accounting conservatism variable (Y) had a *minimum* and *maximum* values of 16.00 and 18.93 and a *mean* and *Std. Deviation* of 17.4975 and 0.87445.

#### Classical Assumption Test

##### Normality Test

**Table 2. Kolmogorov-Smirnov Test Results**

One-Sample Kolmogorov-Smirnov Test		
		Unstandardized Residual
N		140
Normal Parameters <sup>a,b</sup>	Mean	,0000000
	Std. Deviation	,45966503
Most Extreme Differences	Absolute	,058
	Positive	,054
	Negative	-,058
Test Statistic		,058
Asymp. Sig. (2-tailed)		,200c,d

Source: Data processed by SPSS 2

Based on the table, the results of the *Kolmogorov-Smirnov test* obtained a large Asym value. *Sig. (2-tailed)* by  $0.200 > 0.05$ . This shows that residual data has been distributed normally.

### Multilinearity Test

**Table 3. Multilinearity Test Results**

Coefficients <sup>a</sup>			
		Collinearity Statistics	
Type		Tolerance	VIF
1	Debt Covenant	,954	1,048
	Political Cost	,952	1,051
	Financial Distress	,969	1,032
	Risk of Litigation	,950	1,053

Source: Data processed by SPSS 22

The results of the multilinearity test showed a *Tolerance* value of  $> 0.1$  and a VIF value of  $< 10$ . So it can be concluded that there is no multilinearity between variables in this regression model.

### Autocorrelation Test

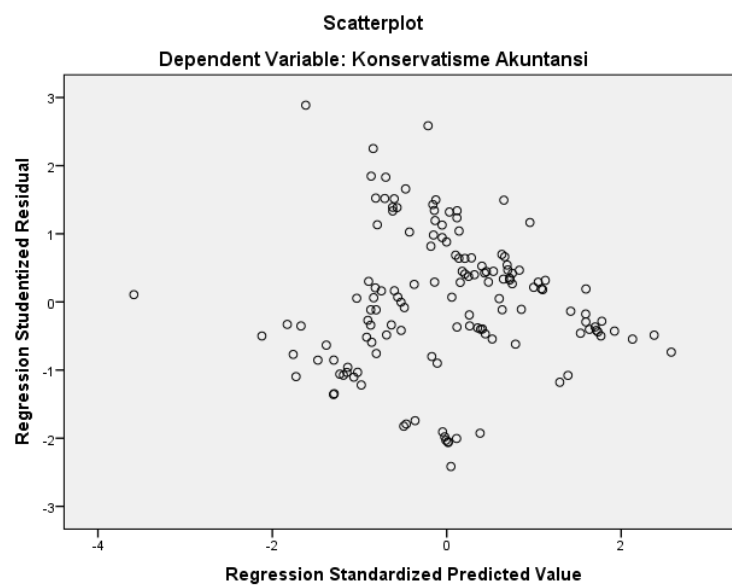
**Table 4. Autocorrelation Test Results**

Model Summary <sup>b</sup>					
Type	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	,709a	,603	,729	,01859	2,107

Source: Data processed by SPSS 22

There is no autocorrelation if  $(du < dw < 4 - du)$ , the data  $du$  is 1.7830 so  $4 - du$  ( $4 - 1.7830 = 2.217$ ) then the result is  $1.7830 < 2.107 < 2.217$ . It can be concluded that the regression model in this study does not have an autocorrelation.

### Heteroscedasticity Test



**Figure 2. Heteroscedasticity Test Results**

From the figure, *the scatterplot* shows the dots scattered above and below the number 0 on the Y-axis.

### Multiple Linear Regression Analysis

**Table 5. Multiple Linear Regression Analysis Results**

**Coefficients<sup>a</sup>**



Type	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
1 (Constant)	20,350	,314		64,872	,000
Debt Covenant	-,712	,100	-,477	-7,087	,000
Political Cost	-,084	,013	-,449	-6,657	,000
Financial Distress	-,008	,006	-,081	-1,209	,229
Risk of Litigation	-,003	,003	-,070	-1,030	,305

Based on the table above, a multiple linear regression equation is generated as follows:

$$Y = 20,350 - 0,712X_1 - 0,084X_2 - 0,008X_3 - 0,003X_4 + e$$

Based on the multiple linear regression equation above, an analysis can be taken that:

- The value of the constant ( $\alpha$ ) is 20.350, meaning that if the variables of *debt covenant*, *political cost*, *financial distress*, and *litigation risk* are constant or zero, then accounting conservatism is 20.350.
- The regression coefficient of the *debt covenant variable* is -0.712 with a negative coefficient direction. This means that if every additional *debt covenant* variable is added, accounting conservatism will decrease by 0.712 units.
- The regression coefficient of the *political cost variable* is -0.084 with a negative coefficient direction. This means that if every addition of *the political cost* variable, accounting conservatism will decrease by 0.084 units.
- The regression coefficient of the *financial distress variable* is -0.008 with a negative coefficient direction. This means that if every addition of *the financial distress* variable, accounting conservatism will decrease by 0.008 units.
- The regression coefficient of the *litigation risk variable* was -0.003 with a negative coefficient direction. This means that if each addition of *litigation risk* variables, accounting conservatism will decrease by 0.003 units.

## Hypothesis Test

### Model Feasibility Test (Test F)

**Table 6. Model Feasibility Test Results (Test F)**

ANOVAa						
Type		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	20,877	4	5,219	23,991	,000B
	Residual	29,370	135	,218		
	Total	50,247	139			

Source: Data processed by SPSS 22

The feasibility test of the model (Test F) obtained a calculated F value of 23.991 > the  $F_{table}$  was 2.44 with a significance value of  $0.000 < 0.05$ . Therefore, it can be concluded that *debt covenant*, *political cost*, *financial distress*, and litigation risk are feasible to affect the variables of accounting conservatism.

#### Individual Parameter Significance Test (Statistical Test t)

**Table 7. Statistical Test Results t**

Coefficientsa						
		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	20,350	,314		64,872	,000
	Debt Covenant	-,712	,100	-,477	-7,087	,000
	Political Cost	-,084	,013	-,449	-6,657	,000
	Financial Distress	-,008	,006	-,081	-1,209	,229
	Risk of Litigation	-,003	,003	-,070	-1,030	,305

1. The *debt covenant* produces a calculated  $t$  value of  $-7.087 > t_{table} 1.977$  while the significance value is  $0.000 < 0.05$ , then the hypothesis is accepted. So, it is concluded that *debt covenants* have a negative effect on accounting conservatism.
2. *Political cost* produces a calculated  $t$  value of  $-6.657 > t_{table} 1.977$  while the significance value is  $0.000 < 0.05$ , then the hypothesis is rejected. So, it is concluded that *political cost* has a negative effect on accounting conservatism.
3. *Financial distress* produces a  $t$ -value of  $-1.209 < t_{table} 1.977$  while the significance value is  $0.229 > 0.05$ , so the hypothesis is rejected. So, it is concluded that *financial distress* has no effect on accounting conservatism.
4. The risk of litigation results in a calculated  $t$ -value of  $-1.030 < t_{table} 1.977$  while the significance value is  $0.305 > 0.05$ , so the hypothesis is rejected. Thus, it is concluded that litigation risk has no effect on accounting conservatism.

#### Determination Coefficient Test ( $R^2$ )

**Table 8. Determination Coefficient Test Results ( $R^2$ )**

Model Summary <sup>b</sup>					
Type	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	,709a	,603	,729	,01859	2,107

Source: Data processed by SPSS 22

In the table above, it can be seen that the Adjusted *R Square value* is 0.729. The results of the determination coefficient show that 72.9% of accounting conservatism is influenced by the variables *of debt covenant, political cost, financial distress*, and litigation risk. While the remaining 27.1% was influenced by other variables that were not studied in this study.

## **Discussion**

### **The Influence of *Debt Covenant* on Accounting Conservatism**

Based on the results of the study, a regression coefficient value of -0.712 was obtained with a negative direction and a calculated t value = -7.087 and  $t_{table} = 1.977$  which showed that the calculated t value<sub>was</sub>  $-7.087 > t_{table} 1.977$  and the significance value was  $0.000 < 0.05$ . Which means that the *debt covenant* variable has a negative effect on accounting conservatism shows that the hypothesis is accepted.

*Debt covenant hypothesis* In positive accounting theory, it is stated that the higher the debt or loan that the company gets, the presentation of financial statements will be unconservative. This is because the company wants to show good performance to external parties, so that external parties believe that the safety of their funds is guaranteed (Watts & Zimmerman, 1990). Results *Debt Covenant* has a negative effect on accounting conservatism supported by research Riyadi (2022), Sinambela & Almiliah (2018), Arsanto (2017), Zuhriyah (2016) and Ud Din *et al.* (2017) that the larger the level of debt, the more management behavior prefers to apply less conservative accounting reporting principles. On the other hand, companies that apply the principles of accounting conservatism will have less debt costs due to the acquisition of smaller interest rates from creditors and also as agency fees for resolving uncertainty in the arrangement *principal-agent*.

### **The Effect of *Political Cost* on Accounting Conservatism**

Based on the results of the study, a regression coefficient value of -0.084 was obtained with a negative direction and a calculated t value = -6.657 and  $t_{table} = 1.977$  which

showed that the calculated t value<sub>was</sub>  $-6.657 > t_{table} 1.977$  and the significance value was  $0.000 < 0.05$ . Which means that the variable *political cost* has a positive effect on accounting conservatism shows that the hypothesis is rejected.

Iskandar & Sparta (2019) in measuring *political cost* This study uses measurements *size* which describes the size of a company. In agency theory (*Agency Theory*) assumes that each individual acts in their own interests so that a possible agency problem is the existence of information asymmetry (Rahayu, 2017). The results of the study show that there is a negative influence between *political cost* and accounting conservatism where the larger the size of the company, the less conselective, because in large companies the asymmetry of information is relatively smaller because large companies disclose more information to the public, which can reduce the demand for conservative accounting (Reskino & Vemiliyarni, 2016).

### **The Effect of *Financial Distress* on Accounting Conservatism**

Based on the results of the study, a regression coefficient value of  $-0.008$  was obtained with a negative direction and the  $t_{value} = -1.209$  and  $t_{table} = 1.977$  which showed that the  $t_{value}$  was  $-1.209 < t_{table} 1.977$  and the significance value was  $0.229 > 0.05$ . Which means that the variable of *financial distress* has a negative effect on accounting conservatism, indicating that the hypothesis is rejected.

Akyuwen *et al.* (2022) *Financial distress* occurs when the company fails or is unable to fulfill its obligations to creditors, due to limited funds. The results of the study have no effect *Financial distress* on accounting conservatism in line with research Hsu *et al.* (2017), Elaisza (2018) and Haryadiet al. (2020) that *Financial distress* causing companies to need more funding in spending or spending on operational activities and payment of obligations. If the company faces a financial crisis and still applies conservative accounting, then the presentation of financial statements becomes pessimistic so that it conveys a negative signal to external parties, especially creditors, so that creditors will not lend their funds for the survival of the company.

### **The Effect of Litigation Risk on Accounting Conservatism**

Based on the results of the study, a regression coefficient value of  $-0.003$  was obtained with a negative direction and a  $_{calculated} t \text{ value} = -1.030$  and  $t_{table} = 1.977$  which showed that the  $t_{value}$  of  $-1.030 < t_{table} 1.977$  and a significance value of  $0.305 > 0.05$ . Which means that the litigation risk variable has a positive effect on accounting conservatism shows that the hypothesis is rejected.

The absence of litigation risk on accounting conservatism is supported by research Lucky (2019), Goddess *et al.* (2014) and Suryandari & Priyanto (2012) because it is likely to be caused by the weakening of law enforcement in Indonesia, which results in weak managers' anticipation of litigation risks. A low litigation risk score does not guarantee that the company will be safe from the threat of litigation. When a company experiences litigation from one of the parties, the investor or creditor does not guarantee that the other investor or creditor will sue the company, as long as its interests are fulfilled and accepted by the company even though the financial statements presented by the company do not show conservatism.

## E. CONCLUSIONS AND SUGGESTIONS

### Conclusion

Based on the results of the data analysis in the study, it can be concluded that *debt covenant* and *political cost* have a negative influence on accounting conservatism in the mining sector listed on the IDX in 2016-2022 while *financial distress* and litigation risk have no effect on accounting conservatism.

### Suggestion

Some suggestions from the author that can be given in line with the results of the research are:

1. Further research is expected to add or replace with other independent variables that are more appropriate that are suspected to affect accounting conservatism such as *growth opportunities*, profitability, managerial ownership and others.
2. Further research is expected to use other samples, namely other than the mining sector, so that the research reach does not only focus on the sector researched in this study.

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