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Audit Committee Effectiveness and Accounting Conservatism Practices: The Case of Manufacturing Companies

Ratieh Widhiastuti[12], Abdul Rohman[3], Puji Harto[3]*

[1]Economic Education Department, Faculty of Economics and Business, Universitas Negeri Semarang, Semarang, Indonesia

[2]Doctoral Program in Economics, Faculty of Economics and Business, Universitas Diponegoro, Semarang, Indonesia

[3]Accounting Department, Faculty of Economics and Business, Universitas Diponegoro, Semarang, Indonesia

*Correspondence: E-mail: ratieh.widhiastuti@mail.unnes.ac.id

ABSTRACT

This study aimed to see how financial distress, conflicts of interest, and litigation risk affected accounting conservatism when an audit committee was present as a moderating variable. The population was manufacturing companies indexed at the Indonesia Stock Exchange (IDX) in 2019-2021. The tool employed descriptive and moderation regression analysis. The findings of this research showed that financial distress, conflicts of interest, and litigation risk had a significant positive effect on accounting conservatism. However, the audit committee could not moderate the impact of financial distress, conflict of interest, and litigation risk on accounting conservatism. Financial distress had a significant positive effect on accounting conservatism. Litigation risk was one of the negative impacts of agency problems in a company. These results supported the agency theory, which explains that lawsuits or litigation risks can occur due to differences in interests between management and investors, creditors, or the government. This research contributes to accounting standard policymaking, particularly in applying the conservatism principle. Based on the occurrences and findings of past investigations, which are still inconsistent, the originality of this study was to see how financial distress, conflicts of interest, and litigation risk affected accounting conservatism by including the audit committee variable as a moderating variable.

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1. INTRODUCTION

The principle of accounting conservatism in the International Financial Reporting Standards (IFRS) is no longer a new conceptual framework. The prudence concept replaces it because it is incompatible with IFRS's theoretical framework (Rahayu *et al*., 2018). However, in certain areas, the use of it is still maintained. Although Indonesian accounting standards have converged with IFRS since 2012, the Pernyataan Standar Akuntansi Keuangan (PSAK) still follows the conservative concept when preparing financial statements. This may be observed in the option of accounting methods described in numerous PSAK standards, which allow each organization to choose an accounting system that best suits its needs. The accounting approach chosen demonstrates that the PSAK adheres to accounting conservatism. The notion of accounting conservatism may be found in various PSAK Statements, including PSAK No. 14 on inventory and options for computing inventory costs. PSAK No. 16 on fixed assets and alternatives for determining fixed asset depreciation costs.

Theories relating to the application of accounting conservatism are agency theory. Jensen and Meckling's (1976) agency theory is a contract between the shareholder (principal) and the manager (agent), both of whom seek to maximize welfare (Sulastri and Anna, 2018). As a party with a direct role in the company's operational activities, it allows managers to have more information than shareholders, making it harder for shareholders with little information to govern the company controlled by the management. The disparity in knowledge can allow agents to falsify financial data without the principal being aware of the actual situation (Putra *et al*., 2019). Manipulation of financial harm to several parties, so steps must be made to avoid it (Chouaibi and Belhouchet, 2023). Conservatism in producing the company's financial statements is one of the steps that may be taken to prevent agency issues. The link between the application of conservatism and agency theory is that the more capital-intensive a company can increase the protection provided by investors (Ahmed *et al*., 2020). Other researchers who use agency theory in researching accounting conservatism include Abdurrahman *et al*. (2020), Haider *et al*. (2021); Li *et al*. (2020); Mishra (2014); Shoorvarzy *et al*. (2012); (Zhong and Li, 2017); (Ha, 2019) the application of accounting conservatism can reduce conflicts of interest between management and users.

Agency Theory assumes that each act for their interests. A conflict of interest between the agent and the principal might lead to the emergence of agency problems. One effort that can be made to prevent agency problems is to apply conservatism in the preparation of company financial statements. Putri (2017) and Laux and Laux (2023) stated that accounting conservatism can reduce Agency Costs so that companies can produce accurate, quality, accountable financial reports and provide transparent information so as not to mislead investors and creditors. This aligns with the views of Putra *et al*. (2019) who stated that Conservatism is a responsible response to uncertain conditions that protect shareholders' and creditors' rights and interests by establishing better verification requirements for recognizing good news than negative news. Nevertheless, the current application of accounting conservatism in Indonesia is still relatively low. The importance of research into the application of accounting conservatism indicates the quality of the numbers in financial reports. Decreasing stakeholder confidence in the numbers in financial reports requires much research to ensure the quality of reporting prepared by management.

This can be proven by the results of several previous studies, which show that accounting conservatism in Indonesia has not been implemented optimally, where the average value of accounting conservatism is still low and tends to approach the minimum value of conservatism. Some of the results of these studies prove that there is still financial information that is not conservative, and this can cause conflicts between agents and the principal of the company

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either due to losses or mistrust of investors with managers in the form of investor suspicion or mistrust in the management of the company itself. Many earlier studies have examined the elements that influence the adoption of accounting conservatism, but the results have been inconsistent. Some of them are (1) financial distress; positive effect (Ahmed and Duellman, 2007; Rahayu *et al*., 2018); negative effect (Dewi and Suryanawa, 2014; Pratama and Yulianto, 2015; Rivandi and Ariska, 2019; Sumiari and Wirama, 2016; Zulfiati and Anisya, 2017); no effect (Putri, 2017; Septianto, 2016); (2) conflict of interest, positive impact (Ahmed and Duellman, 2007; Paramita and Cahyati, 2013; Suryandari and Priyanto, 2011); no impact (Wisuandari and Putra, 2018); (3) litigation risk, positive effect (Nasir, Ilham, and Utara, 2014; Rahayu, 2017; Suryandari and Priyanto, 2011; Zulfiati and Anisya, 2017); negative effect (Ananto *et al*., 2017); no effect (Pratama and Yulianto, 2015); and (4) audit committee (Adusei and Obeng, 2019; Feng *et al*., 2020; Lawati and Hussainey, 2021; Sharma and Kaur, 2021; Sultana, 2015).

Based on the occurrences and findings of past investigations, which are still inconsistent, the objective of this study was to see how financial distress, conflicts of interest, and litigation risk affected accounting conservatism in manufacturing companies that go public in Indonesia by including the audit committee variable as a moderating variable. The novelty in this research differentiates it from previous research by presenting the audit committee variable as a moderating variable. This study aimed to examine the direct effect of financial distress, conflict of interest, and litigation risk on the principle of accounting conservatism practices and the indirect effect from the dependent variable to the accounting conservatism moderated by the audit committee.

2. METHODS

In this study, the population was manufacturing companies listed on the Indonesia Stock Exchange (IDX) between 2019 and 2021. Purposive sampling was employed to pick the samples for this study. According to the tabulated statistics, there were 133 manufacturing companies listed on the Indonesia Stock Exchange (IDX) between 2019 and 2021. Based on the sample determination criteria, it resulted in 90 research analysis units, which consisted of 30 manufacturing companies with three accounting periods. The variables used in this study were accounting conservatism as the dependent variable, financial distress, conflict of interest, and litigation risk as the independent variable, and the audit committee as a moderating variable. The analysis tool used descriptive analysis and moderation regression analysis. Accounting conservatism (ACV) is a financial reporting philosophy that states that a corporation should not be in a hurry to identify and measure assets and profits and should acknowledge losses and debts that are expected to materialize (Watts, 2003). Accounting conservatism in this research is measured by the following formula.

$$Cons = \frac{(NI + Depr) - CFO}{TA} \; x \; (-1)$$

Cons are accounting conservation; NI is net income; Depr is depreciation; CFO is cash flow from operating activity; and TA is total assets. This measurement refers to Savitri (2016).

Financial distress (FD) occurs when a company cannot meet its payment obligations or when a cash flow estimate shows that it will soon be unable to do so (Ramadhoni *et al*., 2014). The measurement of this research refers to Zmijewski (1984), formulated as follows.

$$X = -4{,}3 - 4{,}5X1 + 5{,}7X2 + 0{,}004X3$$

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X is financial distress; X1 is ROA is for Return on Asset; X2 stands for leverage (Debt Ratio); and X3 stands for liquidity (Current Ratio). If the score produced from the equation is more significant than zero (zero), the company is expected to go bankrupt; however, if the score is less than zero (zero), the company is anticipated to have no potential for bankruptcy.

Conflicts of interest (CI) occur between investors and creditors if the company has a source of funding from debt (Jensen and Meckling, 1976). Paying dividends that are too high can threaten creditors because it will reduce assets that should be available for repayment of the company's debts to creditors, so the calculation of conflicts of interest is formulated as follows (Paramita and Cahyati, 2013).

$$\text{Dividend} = \frac{\text{Dividend}}{\text{Total assets}} \times 100\%$$

Litigation risk (LR) relates to the position of creditors and investors as external parties (Nasir, Ilham, dan Yusniati, 2014). Lawsuits that can occur in companies can be avoided by implementing accounting conservatism in presenting financial statements so that the value in the company's financial statements can be accounted for (Sinambela and Almilia, 2018).

$$Asset\ Growth = \frac{Total\ Assets_t - Total\ Assets_{t-1}}{Total\ Assets_{t-1}}$$

The audit committee (ACO) can examine and ensure that the company's accounting principles apply to applicable accounting standards. The number of company-owned audit committees measures the audit committee. The research model developed in this research is explained in **Figure 1**.

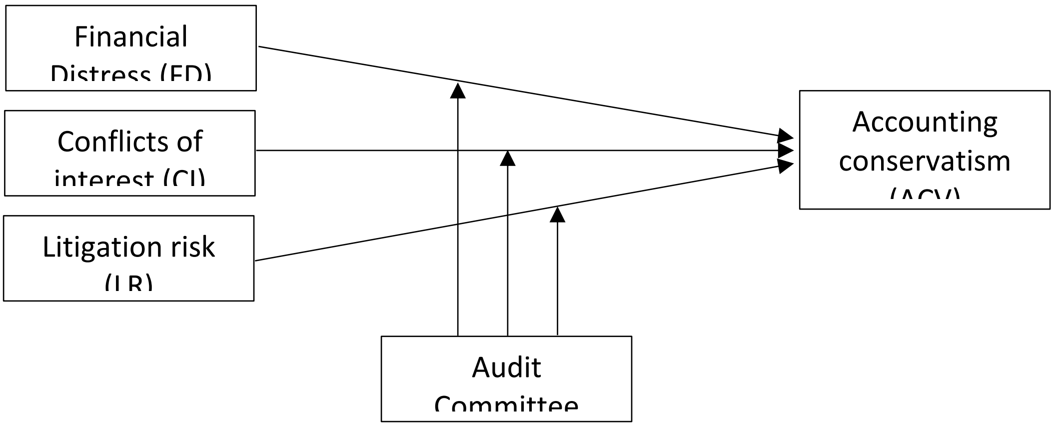

Figure 1. Research model

3. RESULTS AND DISCUSSION

3.1. Descriptive statistics

Descriptive analysis test results showed the distribution of research data in detail, which is explained in **Table 1**. The application of accounting conservatism showed a mean of 0.2404. The mean of financial distress showed a value of 3,6198. The mean of conflict of interest was 6.28%. Asset growth as a proxy for litigation risk showed a mean of 0.0440, while the audit committee's mean was 3.0222.

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Table 1. Results of descriptive statistical analysis of research variables

	N	Minimum	Maximum	Mean	Std. Deviation
FD	90		27,63	3,6198	4,90826
CI	90	,00	,43	,0628	,10344
LR	90	-,88	,62	,0440	,20311
ACO	90	2,00	5,00	3,0222	,47352
ACV	90	-,37	1,15	,2404	,26785
Valid N (listwise)	90				

Source: Secondary data processed, 2022

3.2. Empirical Analysis

This study uses panel data and research hypothesis data processing using the help of Eviews. Before testing the hypothesis, it is first carried out testing to determine the selected statistical model. The Chow test was used in this study to compare the Common Effect Model (CEM) with the Fixed Effect Model (FEM) to determine which model is better for use in the study. Based on **Table 2**, it is known that the probability of cross-section F shows a value of 0.0000. This value can be interpreted as the selected model is the Fixed Effect Model (FEM) because the cross-section probability value of F is less than 5.

Table 2. Chow test result

Redundant Fixed Effect Test
Equation: Untitled
Test cross-section fixed effects

Effects Test	Statistic	d.f.	Prob.
Cross-section F	3,046979	29,54	0,0000
Cross-section Chi-square	120,593153	29	0,000

Source: Secondary data processed, 2022

The next step is to carry out the Hausman test which is carried out to test the model and determine which model is more appropriate between the Fixed Effect Model (FEM) and the Random Effect Model (REM). The Hausman test presented in **Table 3** shows the value of Prob. Random cross-section of 0.0294. Therefore, it can be said that the model chosen between the Fixed Effect Model (FEM) and the Random Effect Model (REM) is the Fixed Effect Model because it has a value of Prob—random cross-section less than 0.05. Based on the model test conducted through the Chow test and the Hausman test, it is known that of the three-panel data research models, which include the Common Effect Model, Fixed Effect Model, and Random Effect Model, one model is considered the most appropriate to use, namely the Fixed Effect Model. Then, there is no need to perform the Lagrange Multiplier Test.

Table 3. Hausman test result

Correlated Random Effects – Hausman Test
Equation: Untitled
Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq d.f.	Prob
Cross-section random	14,024701	6	0,0294

Source: Secondary data processed, 2022

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The normality test, the heteroscedasticity test, the autocorrelation test, and the multicollinearity test were all used to assess classical assumptions before hypotheses were tested. It can be observed from the results of the One-Sample Kolmogorov-Smirnov test that the data was free of the normalcy problem, with a significance value of 0.163. The results of the multicollinearity test revealed that all variables had tolerance values of greater than 0.1 and VIF values of less than 10, indicating that the model was free of multicollinearity. The park test, which was used to examine the symptoms of heteroscedasticity, yielded a significant value of more than 0.05 for each variable, indicating that the model was free of heteroscedasticity symptoms. The autocorrelation test using the Run Test produced an Asymp. Value. Sig. (2-tailed) = 0.090. Adjusted R Square produced a value of 0.784. According to these findings, financial distress, conflict of interest, and litigation risk, with the presence of an audit committee as a moderating variable, had a 78.4 percent contribution to the application of accounting conservatism. Hypothesis test results can be seen in **Table 4**.

Table 4. Results of hypothesis testing

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Dependent Variable: Accounting Conservatism (ACV)				
C	0.080413	0.031844	2.525226	0.0145
FD	0.024155	0.007066	3.418541	0.0012**
CI	1.577722	0.593747	2.657231	0.0103**
LR	0.331414	0.072964	4.542170	0.0000**
FD*ACO	9.95E-05	0.000683	0.145812	0.8846
CI*ACO	-0.085742	0.081677	-1.049769	0.2985
LR*ACO	0.004069	0.017516	0.232312	0.8172
** significant at the 5% level				

Source: Secondary data processed, 2022

3.3. Effect of Financial Distress on the Application of Accounting Conservatism

Financial distress in this study was measured using the Z-Score formula revised in the Altman Model (1983). Based on the results of hypothesis testing, it showed that financial distress had a significant positive effect on accounting conservatism. Based on the results of descriptive analysis, it showed that the average value of financial distress is 3.6198. Most manufacturing companies had financial difficulties because the Z-score was already higher than three. Suppose the value of financial distress was getting higher. In that case, it can affect the company's operational activities, including decision-making and raising conservative financial statements to avoid future risks. According to agency theory, management will aim to lessen the organization's information asymmetry to avoid any future unfavorable consequences. Accounting conservatism was a signal from management to investors that the company had produced high-quality earnings and was continuing to receive favorable judgment from investors (Sulastri *et al*., 2018).

Financial distress is a condition where a company cannot fulfill its current obligations, which are due, for example, to business debts, tax debts, and short-term bank debts (Rahmat, 2020). Besides aiming to maintain investor confidence, the application of accounting conservatism of companies experiencing financial distress was also intended to avoid overstating the value of financial statements. With the existence of understated financial statements, the company will be more careful in making decisions and setting policies to overcome financial distress and minimize the risks that might occur. This was supported by the

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research of Alfian and Sabeni (2013), which showed that if the principle of accounting conservatism were appropriately applied, it would be the most rational guideline in a problematic situation of the company. The results of this study were in line with the results of research conducted by Putri *et al.* (2017); Rahayu *et al.* (2018); and Aier *et al.* (2014) which showed that financial distress had a significant positive effect on accounting conservatism. After share repurchase, companies with high financial distress have not reduced the application of impression management practices (Li *et al*., 2020). The results of this study are in line with the findings of Wen-Hsin Hsu *et al.* (2011), which found a positive relationship between financial distress and earnings-sensitivity difference (ESD) as a proxy for accounting conservatism, financial difficulties did not interfere with the reliability of ESD as an indicator of conditional conservatism. When a firm reaches the stage of financial distress, the bondholders depend on timely recognition of losses in order to take control of critical firm decisions, and this applies even more so when covenants bind contracts of the firm (Abdurrahman *et al*., 2020; Biddle *et al*., 2020; Collins *et al*., 2017).

3.4. Effect of Conflicts of Interest on Accounting Conservatism

A conflict of interest was one agency problem between a company's agent and principal. Conflicts of interest in this study were proxied by return on assets, dividends, and leverage. Hypothesis test results showed that the conflict of interest had a significant positive effect on accounting conservatism. This can be interpreted as a company's higher conflict of interest would encourage management to increase accounting conservatism in corporate financial reporting. Opportunistic management can cause overstating of the company's financial statements. This can positively impact the company in the near term because the principal would value it more than it was. However, if the actual conditions were revealed and the company could not meet its obligations in the future, it would trigger a conflict of interest between the agent and the principal. It can hurt the company, so to minimize the negative impact, the company would apply accounting conservatism to company financial statements (Liu and Elayan, 2015). Accounting conservatism is favorably associated with managerial skill, and managers are encouraged to implement it if it provides personal benefits (Haider *et al*., 2021; Kartikasari *et al*., 2022).

Conflicts of interest occurred because investors tried to take advantage of creditor funds through excessive dividend payments, asset transfers, acquisition of assets, and replacement assets. This would cause creditors to worry about the security of the funds entrusted to the company concerned. To overcome these concerns, companies would tend to apply accounting conservatism to continue gaining creditors' trust as a source of corporate funding. The results of this study were in line with the results of research conducted by Paramita and Cahyati (2013); Suryandari and Priyanto (2011); LaFond and Watts (2008); Isniawati *et al.* (2018) showed that conflicts of interest had a positive effect on accounting conservatism. The quality of information that can be extracted from conservatively prepared financial reports and reliable accrual presentation obscures information control between investors and management (Wibowo, 2021).

3.5. Effect of Litigation Risk on Accounting Conservatism

Litigation risk was one of the negative impacts of agency problems in a company. The results of hypothesis testing showed that litigation risk had a significant positive effect on accounting conservatism. Three of the four factors, namely the principle of conservatism, company operations, and litigation risk, are positively related to applying the principle of conservatism (Ge *et al*., 2019; Hong *et al*., 2020; Shawn *et al*., 2019). These results supported the agency theory, which explains that lawsuits or litigation risks can occur due to differences in interests between management and investors, creditors, or the government. Suppose the company reports that the assets and profits are not following the actual condition of the company or tend to be excessive. In that case, the company can be said to make a public forgery that will trigger lawsuits made by the parties concerned.

Lawsuits incurred by companies would incur high agency costs, such as the cost of recovering the company's image. This certainly affected the sustainability of the company in the future. Therefore, to minimize this, management would improve to apply the principles of accounting conservatism in corporate financial reporting. Research results from Abdurrahman *et al*. (2020) show that companies will recognize losses promptly as the company's debt covenants increase in order to avoid potential problems in the debt market. The results of this study were in line with several previous studies, including research conducted by Rahayu *et al*. (2018) and Terzaghi *et al*. (2018) which showed that litigation risk had a significant positive effect on accounting conservatism. However, the study's results contradicted the research of Suryandari and Priyanto (2011); and Manchiraju *et al*. (2021), which showed that litigation risk negatively influenced accounting conservatism. Company management will be more conservative when facing high litigation risk (Basu and Liang, 2019; Black *et al*., 2022; Chen *et al*., 2021; Khurana *et al*., 2006; G. Liu and Sun, 2022; Ramanan, 2014; Zulfiati and Anisya, 2017)

3.6. Effect of Financial Distress on Accounting Conservatism with the Audit Committee as a Mediating Variable

Hypothesis test results indicated that the audit committee could not moderate the effect of financial stress on accounting conservatism. It can be interpreted that the audit committee cannot strengthen or weaken the effect of financial distress on accounting conservatism. The results of the descriptive statistical analysis stated that 87.78% of manufacturing companies that were the unit of analysis had an audit committee of three people where the number was the minimum number according to the decision of the Chairman of BAPEPAM-LK Kep-64 / BL / 2012 regarding the Formation and Guidelines for the Implementation of Audit Committee Work. Based on the descriptive statistical analysis results, the company only met the minimum audit committee requirements set by the Indonesia Stock Exchange (IDX). It did not adjust to each company's size and operational complexity.

The number of audit members not following company conditions resulted in less optimal supervision conducted by the audit committee, especially for companies with high complexity. Therefore, the audit committee could not ensure that the company had presented conservative financial statements whether the company was experiencing financial distress. The results of this study were in line with research conducted by Adhriatik and Ismangil (2019); Bahaudin and Wijayanti (2011); Brilianti (2013); Kao and Sie (2016), which showed that the audit committee did not affect corporate accounting conservatism. Financial distress is a sign that a company is headed for bankruptcy. Companies that have difficulty meeting obligations will prioritize paying debts to creditors before allocating dividends (Immanuel and Prabowo, 2021). The existence of an audit committee is unable to influence management in using accounting conservatism when the company's financial condition is problematic.

3.7. Effect of Conflicts of Interest on Accounting Conservatism with the Audit Committee as Moderation Variables

The hypothesis test results did not indicate that the audit committee could not moderate the effect of conflicts of interest on accounting conservatism. Agency theory explains that the existence of an agency relationship that exists between the agent and the principal can trigger a conflict of interest. As one component of good corporate governance, the audit committee is considered capable of overseeing management performance. Supervision by the audit committee is considered capable of suppressing opportunistic management measures to minimize conflicts of interest within the company. This study found that the audit committee could not strengthen or lessen the effect of conflicts of interest on corporate accounting conservatism, indicating that this argument was not supported. This happened because of the interests brought by the management when preparing financial statements. The audit committee that had no direct task in preparing financial statements could not influence the application of the conservatism principles used by the management.

3.8. Effect of Litigation Risk on the Application of Accounting Conservatism with the Audit Committee as a Moderation Variable

The hypothesis test results showed that the audit committee could not moderate the effect of litigation risk on accounting conservatism. The number of audit committees that were not adjusted to the size and complexity of each organization was one of the findings of this study, so the audit committee functioned less well. In addition, another thing that can cause the audit committee to strengthen or weaken the effect of litigation risk on accounting conservatism was the existence of Regulation of Bapepam-LK year 2012 No. X.I.5, which explains some of the duties and obligations of the audit committee. The regulation outlines the audit committee's primary function, namely the monitoring function. One of the monitoring functions was to conduct a review of the company's financial information so that in companies with high litigation risk conditions, the audit committee did not have the authority or responsibility to participate in determining policies related to the application of accounting conservatism principles in a company's financial statements to reduce the negative impact of the litigation risk. Therefore, the audit committee could not alter the effect of litigation risk on accounting conservatism.

4. CONCLUSION

This research concluded that financial distress, conflicts of interest, and litigation risk significantly affected accounting conservatism. The audit committee could not moderate the effect of financial distress, conflict of interest, and litigation risk on accounting conservatism. Financial distress had a significant positive effect on accounting conservatism. Based on this research, the company was expected to increase the application of accounting conservatism to produce quality financial reports and avoid the negative impacts that may arise in the future. The audit committee could not moderate the effect of financial stress on accounting conservatism. The number of audit members not under company conditions resulted in less optimal supervision conducted by the audit committee, especially for companies with high complexity.

According to the findings of this study, the audit committee could not alter the effect of conflicts of interest on corporate accounting conservatism because of the management's interest in preparing financial statements. The audit committee, which had no direct role in preparing financial statements, could not influence the management's application of conservatism principles. One of the findings of this study was that the number of audit committees was not adjusted to the size and complexity of each company, so the audit committee performed poorly. In determining the number of audit committees, management needed to consider the size and complexity of each company. The limitation of this research is that it focuses on manufacturing companies and has a relatively short research period. Other

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measurements in the audit committee variable were suggested for future research because the audit committee could not moderate the effect of financial distress, conflict of interest, and litigation risk on accounting conservatism in this study. The critical implications of this study's findings are consistent with Zhong and Li's (2017) findings that accounting conservatism is necessary and cannot be eliminated from accounting standards.

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