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Financial Distress, Accounting Conservatism and Litigation Risk in Property & Real Estate Industry During The Covid-19 Pandemic

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Abstract

This research examines the effect of litigation risk on the relationship between financial distress and accounting conservatism in property & real estate industry during the covid-19 pandemic. There are 2 hypotheses in this research. H1: financial distress influence accounting conservatism in property & real estate industry during the covid-19 pandemic. H2: litigation risk affect relationship between financial distress and accounting conservatism in property & real estate industry during the covid-19 pandemic. Linear regression results indicate financial distress has positive influence on accounting conservatism (t value 3.304 and p value < 0.01), and litigation risk affect relationship between financial distress and accounting conservatism (t value 8.515 and p value < 0.01).

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Introduction

As many as 88% of companies in Indonesia are affected by the COVID-19 pandemic. The Ministry of Manpower has conducted surveys in 32 provinces in Indonesia. The survey results show that 9 out of every 10 companies in Indonesia are directly affected by the COVID-19 pandemic. The survey concluded that company losses are generally caused by declining sales so that production must be reduced. The most affected companies are companies engaged in the provision of food and beverage accommodation, real estate and construction companies (Amrullah and Rezkisari, 2020).

The corona pandemic also affected the performance of stock exchange indices and stock market capitalization. As of June 19, 2020, the Indonesia Stock Exchange (IDX) recorded dynamic market and trading indicators. The Jakarta Composite Index (JCI) fell by 21.54 percent to 4,942 and was followed by a decrease in market capitalization by 21.30 percent to Rp5,717 trillion. During 2020, there were two sectors that declined sactically, namely the property and real estate sectors by 33.56 percent (Artanti, 2020)

The uncertainty and prolonged decline in the performance of the hospitality and tourism, retail, food & beverage, office rental and apartment sales sectors have put pressure on the profitability and sustainability of the property sector (Lubis, 2021). This was supported by a decrease in net profit margin in the property and real estate sector during the Covid-19 pandemic (Oktafira and Barusman, 2022). The decline in the financial performance of the property and real estate sector during the pandemic raises question: Is property and real estate's financial distress increasing?

The decline in conservatism resulted in the company's financial performance impressing better. It is supported by several studies (Fitriani, 2020), (Sholikhah and Suryani, no date) dan (Firmasari, 2016). According to signalling theory, financial distress makes management more conservative in preparing financial statements. Higher conservatism in the preparation of financial statements will decrease information asymmetry. So it is hypothesized that financial distress has a positive effect on the conservatism of preparing financial statements. The evidence was found by (Sari, 2020), (Rahayu *et al.*, 2018), (Yusnaini, Maksum and Tarmizi, no date) and (Sulastri and Anna, 2018). But management may choose the oppsite action. When they face to financial distress, they will tend to decrease accounting conservatism level. Their objectives are to make companies' financial performance better in appearance. So financial distress may have negative influence to accounting conservatism.

Many studies had not consistent evidence, so we think there are other variables affected association between financial distress and accounting conservatism. This study investigate the effect of litigation risk variables as moderation variables in the relationship. Low litigation risk will encourage management to reduce accounting conservatism. Conversely, high litigation risk makes management more conservative in presenting its financial statements. This is done to reduce information asymmetry with shareholders.

Literature Review and Hypotheses

Agency Theory

Agency theory explains the relationship between principal and agent (Jensen and Meckling, 1976). In the context of managing a company, investors act as principals and management acts as agents who manage the company. If both parties act to maximize their utility, then management may not necessarily act in the interests of investors. This creates a conflict of interest between the principal and the agent.

Management as an agent who manages the company has more internal company information than the principal. Information asymmetry will arise if there are parties who have more information (Scott, 2003). Agents can take advantage of information asymmetries to maximize their own interests and sacrifice the principal's interests. Conflicts of interest between management and investors accompanied by information asymmetry can encourage management to choose accounting policies that can maximize the company's financial performance.

Signalling Theory

Signalling theory is a theory used to see the condition or signs of a company. The published information will provide signals for investors in making investment decisions (Hartono, 2015). According to Ross (1977) in (Komara et al., 2020), the Signalling Model is concerned with the choice of activity of the manager. According to signalling theory, managers or companies will make decisions that signal the quality of the company to external parties.

Accounting information is one of the media used by management to provide signals to external parties of the company. Investors will understand and interpret these signals in their investment decision making. Accounting information containing predictive value will act as an "early warning signal" for investors. This finding is proven in research by (Puspaningtyas *et al.*, 2022).

Financial Distress

Financial distress is the condition of companies that have difficulty in paying their obligations. Financial problems in the company can be seen in the projection of non-current. cash. This condition makes it difficult for the company to pay its obligations (Moleong 2018) in (Muzharoatiningsih and Hartono, 2022). Financial distress is an early sign that a company will experience financial difficulties before bankruptcy. This condition occurs if the company is unable to fulfill its obligations so that the amount of assets is less than the amount of its liabilities. Thus the company's financial condition is not good, but it has not yet filed for bankruptcy (Meilani & Bukhori 2021) in (Wati, Karamoy and Kalangi, 2022).

According to Ayu et al. (2017) in (Wati, Karamoy and Kalangi, 2022), Internal factors and external factors of the company can cause financial distress. The examples of internal factors are cash flow difficulties, a lot of debt, lack of good corporate governance practises and continuous operational losses. The examples of external factors are increasing in debt interest, inflation and macro economic condition.

Accounting Conservatism

Accounting conservatism is the principle of prudence in financial statement preparation. Suwardjono (2013) in (Zelmiyanti, 2014) define conservatism as someone’s (or company’s or entity’s) attitude dealing with uncertainty. to produce a decision based on the worst outcome of the uncertainty.Wolk et al. (2013) in (Zelmiyanti, 2014) define conservatism as how company or entity tries to choose GAAP to defer revenue recognition, early in recording expense, lower asset presentation and higher debt presentation in financial statements.

Accounting conservatism makes some controversies. Conservatism can avoid entity from opportunistic management practises so it can decrease agency cost. (Beatty, Chen and Zhang, 2011) found evidence that conservatism in financial preparation helped company to decrease debt interest rate. Accounting conservatism helped debitur to solve conflicts between investor and creditor to maintain their hedging after debt payments.

Other studies argued that concervatism had negative influences. (Mashoka and Abu-Hommous, 2018) found evidence about conservatism influence to decrease earning quality. However, (Zadeh, Askarany and Asl, 2022) found Dechow & Dichev model and corporate governance menchanism had moderating effect to the association between accounting conservatism and earning quality.

Financial Distress Influence to Accounting Conservatism

According to signalling theory, accounting informations in the financial statements are tools for managemenst to give positive signal to the investors. This signal is very important to send message about good financial performance. When company faced with financial distress, managements would give signal to investors and creditors about companies' financial condition. So management would be more conservative in the financial statement presentation to avoid conflict with creditors and investors. Financial distress probably has positive influence to accounting conservatism. These studies (Sari, 2020), (Rahayu *et al.*, 2018), (Yusnaini, Maksum and Tarmizi, no date), (Sulastri and Anna, 2018) got evidence about financial distress's positive influence to accounting conservatism.

According to signalling theory and efficient market hypothesis, some researchers found evidence that signal receiver (financial statement user) would give positive signal to information from insider. Insider signal would eliminate information asymmetry. However, signal negative had more impact than positive signal (Yasar, Martin and Kiessling, 2020). (Huang, Zang and Zheng, 2014) conducted cross sectional analysis and get evidence about investors's reaction to negative information. Investors react more strongly to negative information than positive information. This reaction may make management tend to avoid giving negative signals to external parties of the company.

According to agency theory, financial distress may encourage management to try their best to present positive financial performance. This is based on management positions that have more information than investors. Management also tends to maximize its utility while still trying to present financial performance that is relatively better than actual financial performance, when financial distress hits the company. For this reason, management will lower the principle of conservatism in presenting financial statements. Thus, financial distress may negatively affect accounting conservatism. Several studies have found negative evidence of the effect of financial distress on accounting conservatism (Fitriani, 2020), (Sholikhah and Suryani, no date), (Firmasari, 2016).

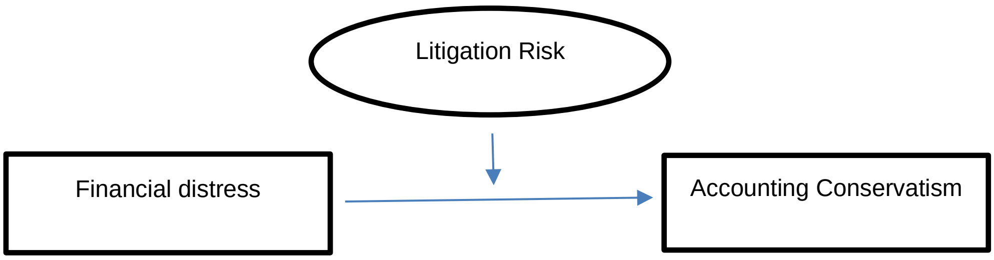
H1: Financial distress affected accounting conservatism in the property and real estate sector in the Indonesian Stock Exchange during the Covid-19 pandemic

Litigation Risk Effect to the Association between Financial Distress and Accounting Conservatism

When the company faces financial distress and high litigation risk, management will tend to take low-risk actions so that it will be more conservative in presenting financial statements. When the company faces financial distress and low litigation risk, management will reduce the conservatism of presenting financial statements to provide better financial performance.

H2: Litigation risk influences the relationship between financial distress and accounting conservatism.

Research Model



Research Methods

We conduct quantitative research method. The research objects are companies in property & real estate industry in Indonesian Stock Exchange during the covid-19 pandemic. This research use purposive sampling method, which requirements is availability of complete quarterly financial statements. There are 39 companies which released quarterly financial statements and we use year 2020, so we have 156 data. But we found 25 not complete data, so we have 131 data.

There are 3 variables in this research: financial distress, accounting conservatism and litigation risk. We use Altman Z Score to measure financial distress. Altman Z Score consists of 5 variables, X1, X2, X3, X4 and X5. X1 is measured by net working capital to total assets ratio. X2 is computed by retained earnings to total assets ratio. X3 is computed by earnings before interest and tax to total assets ratio. X4 is computed by market value of equity to book value of debt ratio. And X5 is measured by sales to total assets ratio. Then we use these ratio to compute Z score as follows: $Z' = 0.717X1 + 0.847X2 + 3.107X3 + 0.420X4 + 0.998X5$

Based on Z score, companies can be classified into 3 categories: AZ score > 2.9 is safe zone and unlikely to bankrupt, AZ score <1.2 means that company is in financial distress and has high bankruptcy probability, AZ score between 1.2 and 2.9 means that the company is in grey area.

Dependent variable in this study is accounting conservatism. This study referred to Givoly and Hayn (2000). They used comparation between equity market value and equity book value (market to book ratio or M/B ratio) to measure accounting conservatism. M/B ratio>1 means that company apply accounting conservatism. It means company recognize company's book value lower than company's market value. The higher this ratio means the higher the accounting conservatism.

Finally, we test litigation risk as moderating variable. This research referred (Handayani and Wahyudi, 2022) to measure litigation risk by debt to equity ratio (DER). The higher DER means the higher litigation risk.

We formulate linear regression model to get evidence about litigation risk effect to the association between financial distress and accounting conservatism:

$$\mathbf{Conv = \beta 0 + \beta_1 FinDis + \beta_2 FinDis*LitRisk + \varepsilon}$$

Result

Preliminary analysis is conducted by descriptive statistic which are presented in table 1:

Table 1. Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
Accounting conservatism	0.0928	1.8329	0.556456	0.3971474
Financial distress	0.1070	3.6967	1.061773	0.7838946
Litigation risk	0.0603	3.4752	0.688239	0.6862520

Accounting conservatism which had score above 1 means that entity applied conservatism. Mean value of accounting conservatism reflected that entity tend to less conservative. Sample in our study consist of 19 companies which have score>1 and 112 companies which have score<1. This result reflected that majority companies in our sample are less conservative.

Financial distress had mean value 1.06 (4 companies had Z score >2.9, 32 companies had score 1.2-2.9, and 95 companies had Z score <1.2). There are 106 companies which have litigation risk ratio<1, so it reflected that majority companies had safe debt to equity ratio.

Following table (table 2) describes regression result to test research hypotheses:

Table 2. Result

Variabel	Coeficient	t	Significant
Constanta	-0.196	-2.350	0.020
Financial Distress	0.213	3.304	0.001*
Financial Distress*Litigation Risk	0.609	8.515	0,000*
Total	: 131		
R	: 0.660		
R^2	: 0.436		
R^2 adj	: 0.427		
F	: 49.410		
Sign F	: 0,000*		

* significant level 0,001

Regression result has adjusted R square 0.427 and means that 42.7% variation in accounting conservatism are influenced by financial distress and interaction between financial distress and litigation risk variables. F test has score 49.1, it means that our regression model is significant. The last is t test result. Coefficient of financial distress has positive sign and p value 0.001. It means that financial distress has positive effect to accounting conservatism. Interaction between financial distress and litigation risk has positive sign and p value<0.01, so litigation risk act as moderating variable which strengthen the relationship between financial distress and accounting conservatism.

Discussion

Regression result gives us evidence about positive influence financial distress to accounting conservatism. The higher the company's financial distress condition, management will tend to be more conservative in presenting financial statements. This finding is in line with signalling theory. When the company's financial condition declines, management will be more conservative to provide information on the company's financial condition to investors, creditors and stakeholders. This will reduce information asymmetry between management and stakeholders. This finding is consistent with (Sari, 2020), (Rahayu *et al.*, 2018), (Yusnaini, Maksum and Tarmizi, no date)(Damayanty and Masrin, 2022), (Sulastri and Anna, 2018).

This study found evidence of the effect of litigation risk on the relationship between financial distress and accounting conservatism. The positive coefficient of the litigation risk variable indicates that litigation risk strengthen the positive influence of financial distress on accounting conservatism. That is, when the company experiences an increase in financial distress and faces a high risk of litigation, it will encourage management to be more conservative in presenting its financial statements. This evidence is consistent with (Damayanty and Masrin, 2022) who found positive influence of the litigation risk to accounting conservatism.

Conclusion

Financial distress has positive influence to accounting conservatism in property & real estate companies in Indonesian Stock Exchange during the covid-19 pandemic. Litigation risk strengthen the association between financial distress and accounting conservatism. Further researchers are expected to be able to compare litigation risk moderating effect before pandemic, during pandemic and after pandemic.

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