

# Effect of Capital Structure, Audit Quality and Company Profitability on Accounting Conservatism

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## ABSTRACT

This study aims to examine several factors that are thought to affect accounting conservatism, namely Capital Structure, Audit Quality, and Company Profitability. This study uses quantitative methods. The population in this study are all manufacturing companies listed on the Indonesia Stock Exchange. The sample selection technique is based on purposive sampling. The analytical method used in this study is panel regression, which is a combination of cross-sectional data and time-series data. The results showed that the capital structure variable had no effect on accounting conservatism with a value of  $0.1136 > 0.05$ , then the audit quality variable had a significant effect on accounting conservatism with a value of  $0.0014 < 0.05$ , and the company's profitability variable has no effect on accounting conservatism with a value of  $0.9068 > 0.05$ . Based on the results of the Simultaneous Test that the independent variables namely Capital Structure, Audit Quality, and Company Profitability together have a significant effect on accounting conservatism with a Prob value (F-statistic) of  $0.007847 < 0.05$ .

Keywords: Accounting Conservatism, Audit Quality, Capital Structure, and Profitability

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## INTRODUCTION

Capital structure is concerned with how a company finances its overall operations and progress using various sources of funds. In other words, the capital structure of the company is the result of a series of situations, which combine the entrepreneur's financing decisions so that a careful balance between debt and equity sources of financing is not in doubt which is one of the main challenges of the company. (Martinez, Scherger, and Guercio, 2019). According to Modigliani and Miller

(MM theory) the view that the capital structure is irrelevant or does not affect the value of the firm. Thus, to determine the capital structure, it is not only guided by the perfect market firm value. It is undeniable that the existence of the market still has various imperfections such as asymmetric information. Furthermore, agency costs can make the capital structure relevant and affect the value of the company based on many studies to be able to understand the company's capital structure decisions (Mora and Walker, 2015).

Companies in the capital structure usually have an impact on future sources of funds, namely the cost of capital, risk characteristics, liquidity position, investor returns, and company valuation to be able to become core financing decisions (Yukti Bajaj, 2020). Capital structure is concerned with how a company finances its overall operations and progress using various sources of funds. The company's capital structure is the result of a series of situations that combine the entrepreneur's funding decisions, credit allotments of financiers, and market conditions, all of which are conditioned by the phenomenon of asymmetric information (Martinez, Scherger, and Guercio, 2019). Thus the capital structure of a firm and the notion that debt can be interpreted as an important tool for managers are central to the financial and accounting literature. A manager needs to look at the profitability to ensure the company's ability to earn profits and their resources so that the company earns profits and performs well.

In financial theory, profitability is often used as an indicator of the company's fundamental performance that represents management performance. The company's ability to generate profits must be able to attract investors to invest funds to expand the business. Therefore, low profitability will cause investors to withdraw their funds. Profitability, in general, harms capital structure, because there are companies that have a large level of profitability, many decide to apply the level of profitability to the company's activities rather than applying the value or level of debt, this measure is the most frequently used in empirical testing of the effect capital structure on profitability (Lara, Osma, and Penalva 2007).

Conservatism has a function to play a clear role in contracting and has a corporate governance monitoring function. However, it is difficult to know how contracts are affected by conservatism in the unconditional form of accounting bias of known magnitude. Rational agents will only buy bias. In addition, if the bias is not known, it will only reduce the efficiency of the contract. Policymakers are therefore caused by understandable concerns related to the current financial crisis. has prompted a greater emphasis on prudence or conservatism. There are pros and cons in the academic field. Supporters of the value relevance approach to financial reporting tend to like the approach to financial reporting that is built around neutrality (Alabdullah et al, 2018). Accounting conservatism can reduce cash value by playing a role in audit quality. According to Daryaei (2020) in his findings not only confirm the positive relationship between accounting conservatism and cash value in the absence of quality audit mechanisms because it will lead to wrong conclusions about the effect of accounting conservatism and cash value, especially in developing countries where the government is concentrated and institutional ownership

structure. So that audit quality can be measured in terms of the ability of the auditor to report financial distortions voluntarily and not be biased. Furthermore, other studies have shown that audit quality in Iran is at a low level (Hejranijamil, Hejranijamil, and Shekarkhah, 2020).

Tabari and Moradkhani (2015), stated that to improve audit quality one must determine audit fees, revise audit instructions, develop continuing professional education, issue and interpret challenging accounting standards, develop continuous audits. Audit quality and firm growth should play a key role in the agency relationship conservatism and cash retention policies which in turn affect cash value. The factors that are thought to affect accounting conservatism are Capital Structure, Audit Quality, and Company Profitability. The selection of these variables is due to the inconsistency of the results in previous studies so that further research is needed (Hansen, Hong, and Park, 2018). Conservation is one of the important features in accounting. Of course, it was long before the advent of legal innovations such as limited equity liability, broad litigation, regulatory and regulatory standards, and auditing, stock exchanges, public debt, and equity fractional ownership. Whereas accounting standards include requirements for conservative accounting, management has room for discretion as to the extent to which it can report in a more or less conservative manner.

While conservation of conditions requires consideration, for example regarding the existence of a trigger for impairment, unconditional conservatism may require consideration as well, when accounting standards contain criteria for recognizing or disbursing full development costs (Guo, Huang, and Zhang, 2020). According to Tracey (2015), conservatism has been unconsciously included in most accounting standards. Measures of accounting conservatism can be categorized into two groups: conditional and unconditional conservatism. Unconditional conservatism or independent news means that at the initial recording of assets and liabilities, the accounting process will lead to unrecorded goodwill as expected. Conditional or news-dependent conservatism is under negative conditions where book values are written, but under favorable conditions, book values are not written, for example using lower prices or market values in inventory valuation (Anagnostopoulou, Tsekrekos, and Voulgaris, 2020).

Defines conservatism as a selection criterion between accounting principles that lead to the cumulative minimization of transferred income with the recognition of transferred income with slower revenue recognition, faster expense reporting cognition, lower asset valuation, and higher liability valuation. Conservatism is also an asymmetry in reporting earnings that responds more quickly and completely to bad news than good news. The reason is that a conservative bias prevents accounting numbers from being neutral and thus representationally faithful (Laux and Ray, 2020). The capital structure is the ratio or balance of long-term debt to own capital. The content and proportion of long-term debt and equity of the company's assigned preferred stock and common stock. The optimal capital structure is a capital structure that can maintain a balance between risk and return to maximize share prices, of

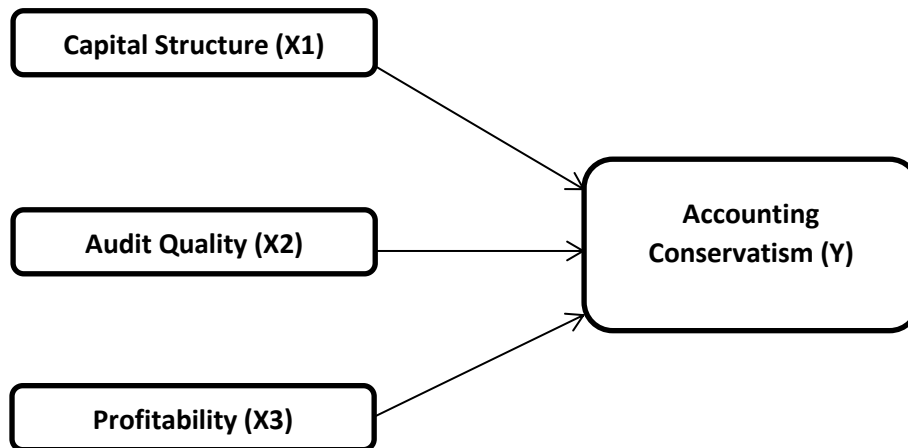
course, ownership and control of shares are family or state ownership, weaker institutional arrangements and legal structures, the importance of political relations, and government intervention. Companies with more conservative financial reporting should adjust their capital structure towards their goals more quickly, especially in companies that rely more on external financing for adjustments (Rahman, Kabir, and Oliver, 2021).

The capital structure of a company and the assumption that debt can be interpreted as an important tool by a manager is the center of the financial and accounting literature. Managers need to ensure that their company's resources are not wasted. However, ongoing reforms in the legal and regulatory framework and governance practices in developing countries allow for the gradual development of their financial systems. Thus motivating the researchers to do the research. The problem capital structure that still applies in developing markets is different from the problems that exist in developed markets today. So to make cross-country comparisons to be more dominant. The capital structure shows how a company finances an operational activity or how to finance company assets. Where the company also needs foreign capital funds or its capital (Salem, Usman, and Ezeani, 2021).

Audit quality is the probability of an auditor finding and reporting an error or mistake that can occur in an accounting system. So that the quality of the audit can be seen whether or not the audit has been carried out by the auditor. Based on the Public Accounting Professional Standards (SPAP) the audit is carried out by a qualified auditor, that is, if it complies with auditing requirements or standards. With the existence of audit quality, it can provide good confidence in financial reporting and information that is credible for users (Salem et al., 2017). The high quality of audits in companies can increase the transparency of the information disclosed, promote efficiency to the capital market and reduce earnings management. Audit quality is always important and is an important element in improving report quality and securing corporate accountability which in turn reduces earnings management. However, with the existence of a sharia audit framework, the Islamic bank uses the same audit framework used by competitors (Bajaj, Kashiramka, and Singh, 2020).

One of the factors that affect the value of the company is the value of a company's profitability. The level of profitability can be measured from several aspects, namely based on earnings per share, return on assets, and return on equity. The company's ability to measure the effectiveness of management is calculated by the profit generated from the sale of the company's investment. Profit and loss calculations help users of financial statements predict future cash flows. Assessment of a company's performance can be seen from the company's ability to generate profits. Profitability can affect the company's capital structure, where the profits generated by the company tend to be greater to meet the needs of funds to carry out an expansion that comes from internal companies (Khalilov and Osma, 2020). According to Hery (2015), the benefits and objectives of the ratio are to measure the company's ability to earn profits for a certain time. Assessing the size of the

company's profits from the previous year with the next year and assessing whether from time to time its profits have developed (Almutairi and Quttainah, 2019).



**Figure 1. Thinking Framework**

## RESEARCH METHOD

This research uses quantitative methods in the context of investigations or investigations that are managed, systematic, data-based, critical, objective, and scientific towards a specific problem to find answers or related solutions which are generally obtained through structured questions. The population of this study is all manufacturing companies listed on the Indonesia Stock Exchange (IDX) for the 2015-2019 period that report complete financial statements and are published in the Indonesian Capital Market Directory 2015-2019. The sample selection technique is based on purposive sampling, which is a sampling method that is limited to certain types that can provide the desired information by setting certain criteria to get a sample of 30 out of 242 units of analysis. The data analysis technique used in this study is panel regression, which is a combination of cross-section data and time-series data (Martinez, Scherger, and Guercio, 2019).

Furthermore, the hypothesis in this study is as follows:

1. H1: Capital structure affects accounting conservatism
2. H2: Company audit quality affects accounting conservatism
3. H3: Company profitability affects accounting conservatism.

## RESULTS AND DISCUSSION

The variable of accounting conservatism in this study is thought to be influenced by several factors, including capital structure, audit quality, and company profitability. Based on the results of panel data regression assisted by the Eviews 9 analysis tool, hypothesis testing has been carried out.

**Table 1. Sampling Results**

Sample Criteria	amount
- Companies listed on the IDX during the 2015-2019 period in the group of manufacturing companies.	242
- Companies that do not have complete data for this study.	59
- Manufacturing companies that present financial statements in currencies other than rupiah.	20
- Companies that are not listed on the IDX in a row during the 2015-2019 observation period.	133
- The total sample during the 2015-2019 research year period.	30

Data: source processed in 2023

**Table 2. Chow Test Test Results**

Effects Test	Statistics	df	Prob.
Cross-section F	4.680843	(29,117)	0.0000
Cross-section Chi-square	115.530742	29	0.0000

Data: source processed in 2023

This test is needed to see the most appropriate model between the common effect and fixed-effect models. The model without individual influence (common effect) is an assumption that combines (pooled) all-time series and cross-section data and uses the OLS (Ordinary Least Square) approach to estimate the meters. The estimation of panel regression parameters with the Fixed Effect Model uses the technique of adding a dummy variable so that this method is often called the Least Square Dummy Variable model. The Chow test aims to determine which model is better to use between the Common Effect models model and Fixed Effects. Based on the table above, the prob value in the Chi-square cross-section is smaller than alpha ( $\alpha$ ) ( $0.0000 < 0.05$ ), then  $H_0$  is rejected. This means that the Fixed Effect model is better to use than the Common Effect model

**Table 3. Hausman test results**

Test Summary	Chi-Sq. Statistics	Chi-Sq. DP	Prob.
Cross-section random	1.344236	3	0.7187

Data: source processed in 2023

In the previous table that uses fixed effects and the table above which uses the random-effects model, all of them show the results of the independent variable having a significant effect on the dependent variable, namely accounting conservatism. However, it has not been able to determine which model will be used, therefore the Hausman test is needed to find out more. Hausman's test aims to determine which model is better between the Fixed Effect model and the Random Effect model. The table above shows that the probability in the random cross-section is greater than alpha ( $\alpha$ ) ( $0.7187 > 0.05$ ), so  $H_0$  is accepted. Thus, it can be concluded that the suitable model used in panel data regression is the Fixed Effect Model (FEM).

**Table 4. T-Test Test Results**

Variable	Coefficient	Std.Error	t-Statistics	Prob.
C	107.942 1	15.68481	6.8819 48	0.000 0
X1	2.74438 8	1.724218	1.5916 71	0.113 6
X2	3.71E- 05	1.14E-05	3.2472 26	0.001 4
X3	- 0.00025 0	0.002135	- 0.1173 06	0.906 8

Data: source processed in 2023

The T-test is used to show how far the influence of the independent variable partially on the independent variable. If the significant profitability value is less than 0.05 (5%) then an independent variable has a significant effect on the dependent

variable. The hypothesis is accepted if the significance level is  $< 0.05$  and the hypothesis is rejected if the significance level is  $> 0.05$ .

The results of the t-test interpretation are as follows:

1. T-test for the effect of capital structure on accounting conservatism. From the results of the probability value in the table above, a value of  $0.1136 > 0.05$  is obtained so that  $H_0$  is accepted and  $H_1$  is rejected. This shows that the capital structure does not affect accounting conservatism.
2. T-test for the effect of audit quality on accounting conservatism. From the results of the probability values in the table above, a value of  $0.0014 < 0.05$  is obtained, so that  $H_0$  is rejected and  $H_1$  is accepted. This shows that audit quality influences accounting conservatism.
3. T-test for the effect of firm profitability on accounting conservatism. From the results of the probability values in the table above, a value of  $0.9068 > 0.05$  is obtained so that  $H_0$  is accepted and  $H_1$  is rejected. This shows that the company's profitability does not affect accounting conservatism.

**Table 5. F Test Test Results**

F-statistics	4.106947	Durbin-Watson stat	0.903552
Prob (F-statistic)	0.007847		

Data: source processed in 2023

The F test is used to test the effect of the independent variables together on the independent variables. If  $F_{count} > F_{table}$ , then  $H_0$  is rejected and  $H_1$  is accepted and vice versa. Based on the results of the F test in the table above, it has a Prob (F-statistic) value of  $0.007847 < 0.05$ , then this research model means that the independent variables, namely capital structure, audit quality, and company profitability together (simultaneously) have a significant effect. against accounting conservatism.

**Table 6. R2 R Test Test Results**

R-squared	0.77822	Mean dependent var	135.9959
Adjusted R-squared	0.58873	SD dependent var	169.7226

Data: source processed in 2023



The termination coefficient is used to find out how much the percentage of the contribution of the independent variables together affects the dependent variable. If  $R^2$  is greater, then the percentage change in the dependent variable (Y) caused by the independent variable (X) is higher. If  $R^2$  is getting smaller, then the percentage change in the dependent variable (Y) caused by the independent variable (X) is getting lower. Based on the table above, it can be seen that the coefficient of determination (r-square) is 0.58873, it can be defined that the contribution of the influence of the independent variable is 58.8%. While the remaining 41.2% is influenced by other factors that are not careful. The results of the analysis and comparison of the proposed hypotheses and are the development of previous researchers: (1) The effect of capital structure on accounting conservatism. From the results of the probability value in the table above, a value of  $0.1136 > 0.05$  is obtained so that  $H_0$  is accepted and  $H_1$  is rejected. This shows that the capital structure does not affect accounting conservatism. (2) The effect of audit quality on accounting conservatism. From the results of the probability values in the table above, a value of  $0.0014 < 0.05$  is obtained so that  $H_0$  is rejected and  $H_1$  is accepted. This shows that audit quality influences accounting conservatism. (3) The effect of company profitability on accounting conservatism. From the results of the probability values in the table above, a value of  $0.9068 > 0.05$  so that  $H_0$  is accepted and  $H_1$  is rejected. This shows that profitability does not affect accounting conservatism.

## CONCLUSION

The results of this study indicate that there is an influence between audit quality on accounting conservatism and other variables capital structure and company profitability do not affect accounting conservatism. The results of the data analysis that has been carried out, the results of the study can be concluded as follows:

1. Partially, the capital structure does not affect accounting conservatism of  $0.1136 > 0.05$  so that  $H_0$  is accepted and  $H_1$  is rejected.
2. Partially audit quality influences accounting conservatism of  $0.0014 < 0.05$  so that  $H_0$  is rejected and  $H_1$  is accepted.
3. Partially, the company's profitability does not affect accounting conservatism of  $0.9068 > 0.05$  so that  $H_0$  is accepted and  $H_1$  is rejected.
4. Simultaneously capital structure, audit quality, and company profitability together have a significant influence on accounting conservatism so that it can be shown by the value of Prob (F-statistic) of  $0.007847 < 0.0$

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