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The Effect of Covenant Debt And Managerial Ownership On Accounting Conservatism

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ABSTRACT

The emergence of the trend of weakening the value of the rupiah is considered to have a negative impact on the company's performance. Quoted from Kontan.co.id, the weakening of the rupiah could weigh on ANTM's performance. Because, in the second quarter of 2018 ANTM suffered a foreign exchange loss of IDR 173 billion. This figure jumped 122% compared to the previous quarter. One of the reasons for this is that 72% of ANTM's debt up to the first semester is denominated in US dollars, which is sensitive to the volatility of the rupiah exchange rate. Based on agency theory, managerial ownership and debt covenants are considered to be able to influence the demand for conservative financial statements. So this study aims to explain and analyze the effect of debt covenants and managerial ownership on conservatism in mining companies listed on the IDX in 2015-2019. The sample used in this study was 55 by testing using multiple linear regression which was processed using SPSS version 25 software. The results of the research showed that debt covenants as measured by performance covenants had no effect, while managerial ownership had a positive effect on conservatism.

Keywords: debt covenant; performance covenants; managerial ownership; accounting conservatism.

INTRODUCTION

The concept of conservatism or *prudence* is one of the important concepts in financial statements. On the other hand, the use of the principle of conservatism by some is considered a controversial principle (Abed, Al-Badainah, & Serdaneh, 2012; Mora & Walker, 2015). Because by using this principle financial statements do not reflect the actual conditions (Ahmed & Duellman, 2011; Suleiman, 2014). The definition of conservatism is explained in SFAC No. 2 issued by the FASB, which is a form of a*prudent reaction*to the uncertainties and risks inherent in business situations so that they are ensured to have been considered wisely. Based on this explanation, under conditions full of uncertainty, managers are allowed to exercise their discretion in terms of measuring assets and liabilities. So in this case, conservatism is an option for managers to take a careful approach to the measurements used so that they can anticipate all losses that may arise (Abed et al., 2012; Yunos, Ismail, & Smith, 2012; Zhong & Li, 2012). 2017).

Although considered a controversial principle, for policy makers the use of conservatism needs to be considered. This is based on concerns over financial problems that may arise (Mora & Walker, 2015). According to Ahmed & Duellman (2013) companies with high levels of leverage have the potential for conflicts that can arise between *bondholders* with *shareholders* so that it will affect accounting conservative. Ahmed, et al., (2015) explain that accounting conservatism helps avoid improper distribution to claim holders, thereby reducing conflicts of interest over dividend policy between shareholders and bondholders. In addition, based on positive accounting theory, debt (*Debt Covenant*financial statements conservative (Aier, Chen, & Pevzner, 2014). It is used to prevent managers' actions to overestimate earnings (Beatty, et al., 2008).

The emergence of a weakening trend in the value of the rupiah against the US dollar in recent years is considered to have a negative impact on the company's performance. Based on the transaction rate of Bank Indonesia, the value of the rupiah had touched the figure of Rp. 15,253 per dollar on October 11, 2018. This phenomenon is considered to be able to burden companies that have debt in the form of US Dollars. In the mining sector, as quoted from Kontan.co.id, the weakening of the rupiah could weigh on ANTM's performance. Because, in the second quarter of 2018 ANTM suffered a foreign exchange loss of IDR 173 billion. This figure jumped 122% compared to the previous quarter. One of the reasons for this is that 72% of ANTM's debt in the first semester is denominated in US dollars, which is sensitive to the volatility of the rupiah exchange rate.

According to Ahmed & Duellman (2013) companies with high levels of leverage have the potential for conflicts that can arise between *bondholders* with *shareholders* so that it will affect accounting conservative. Ahmed, et al., (2015) explain that accounting conservatism helps avoid improper distribution to claim holders, thereby reducing conflicts of interest over dividend policy between shareholders and bondholders. In addition, based on positive accounting theory, debt contracts (*Debt Covenant*) are considered to be able to influence the use of the principle of conservatism because when companies make loans there are demands from creditors to present conservative financial statements (Maier et al., 2014). It is used to prevent managers' actions to overestimate earnings (Beatty, et al., 2008).

At this time, research on accounting conservatism is still needed to answer the problems that arise due to the application of this principle. So the purpose of this study was to determine the effect of the *debt covenant* and managerial ownership on the application of the principle of conservatism. Thus, it is hoped that this research can contribute to the literature on *debt covenants,* managerial ownership and accounting conservatism and can be useful for further research.

RESEARCH METHODS

The type of research used in this research is quantitative research using secondary data. The source of the data used comes from the company's financial statements. The data collection technique used documentation method with purposive sampling method. The criteria for the companies that are sampled in this study are:

1. Mining sector companies listed on the Indonesia Stock Exchange

2. Publishing annual reports or financial reports for the 2015-2019 period.
3. Having managerial ownership

Based on the predetermined criteria, 55 samples were obtained. This sample was then processed using SPSS version 25 software.

Definition and Measurement of Variable

Dependent Variable (Y)

Conservatism

Accounting conservatism in this study refers to the research of Ahmed and Duellman (2013) which is proxied by using total accruals (ConAcc). This measurement was chosen because it only requires data from financial statements. In the measurement with total accruals, the higher the ConAcc value indicates a high level of conservatism as well.

Description:

ConAcc = Level of accounting conservatism.

= Average total accruals for three years.

TA = Income before extraordinary items minus operating cash flows plus depreciation, then divided by the average total assets for three years.

Independent Variable (X)

Debt Covenant Debt

covenant*is*an agreement to protect lenders from manager's actions that conflict with the interests of creditors. According to Callen et al., (2016) Dealscan classifies *debt covenants* into two categories, namely *financial covenants* and *general covenants*. Then Christensen divided the *financial covenants* into two. The first *capital covenant* , which functions to align interests and is measured using indicators of profitability and efficiency. The second is *the performance covenant* which acts as a trigger (*trip wires*) in the transfer of control and *monitoring* which is measured using information about the source and use of capital. In this study, the measurement of debt covenants uses the *covenant mix* (CovMix). which refers to the research of Christensen & Nikolaev (2012).

Note:

Pcov = Amount of *performance covenants*

CCov = Amount of *capital covenants*

Performance Covenant (PCov) was measured using,

Capital Covenant (CCov) is measured using,

Managerial

Ownership Managerial ownership is the total share ownership by management of the total outstanding share capital of the company. Managerial ownership is calculated using the percentage of shares owned by the company's management who actively participates in making company

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decisions (commissioners and directors). According to Lafond and Roychowdhury (2008), companies with *insider* (managerial) ownership have less separation between ownership and control, leading to less conservativeness.

Data Analysis Techniques This

research uses analytical techniques using multiple linear regression. This technique was chosen because there are two independent variables used. Then the data was processed using SPSS version 25. The multiple linear regression model in this study was formulated as follows,

Note:

Y = Total of *capital covenants*

X2 = Constant

1…βn = Coefficient of regression direction

X1 = *Debt Covenant* (CovMix)

= Managerial ownership (Own)

E = *Residual Error*

RESULTS AND DISCUSSION

Table 1. Average value and standard deviation

Descriptive Statistics			
	Mean	Std. Deviation	N
ConAcc	.0163	.06502	55
CovMix	2.5442	10.75400	55
Own	13.8446	20.13104	55

Source: SPSS output v.25

Table 1 shows the results of descriptive statistics with a total sample of 55. Based on this table, the average value and standard deviation of each research variable used are obtained.

Classical Assumption

Test Normality Test

Based on the results of the normality test using the *Kolmogorov Smirnov test* in table 2, a significance value of 0.087 was obtained. This value is greater than the set value of 0.05, which means that the data in this study were normally distributed.

Table 2. Normality Test Results using *One-Sample Kolmogorov-Smirnov Test*

One-Sample Kolmogorov-Smirnov Test		
		Unstandardized Residual
N		55
Normal Parameters,[b]	Mean	.0000000
	Std. Deviation	.05777218
Most Extreme Differences	Absolute	.111
	Positive	.060
	Negative	-.111
Test Statistic		.111
Asymp. Sig. (2-tailed)		.087[c]
a. Test distribution is Normal.		
b. Calculated from data.		
c. Lilliefors Significance Correction.		

Source: SPSS Output v.25

Multicollinearity Test

Table 3 shows the results of the multicollinearity test, from the test results there are no symptoms of multicollinearity. This can be seen in the *tolerance* above 0.100, which is 0.993 and the VIF value is 1.007, which is less than 10.00.

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Table 3. Multicollinearity Test Results

Coefficients[a]								
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	-.004	.010		-.395	.695		
	CovMix	-7.412E5	.001	-.012	-.099	.921 .993	1.007	Own
	.001	.000	.458	3.700	.001	.993	1.007	a
. Dependent Variable: ConAcc								

Source: SPSS v.25 Output Output

Heteroscedasticity Test

From the results of the heteroscedasticity test using the glejser method shown in table 4, a significance value of 0.39 for vMix and 0.074 for Own was obtained. The significant value of all variables is more than 0.05. This means that there is no heteroscedasticity problem in this study.

Table 4. Heteroscedasticity Test Results

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.036	.007		5,600	.000
	CovMix	.000	.000	-.116 -.867	.390	Own
	.000	.000	.244	1,824	.074	a

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. Dependent Variable: ABS_RES

Source: SPSS v.25 . Output

Autocorrelation Test

Table 5. Autocorrelation Test Results

Model Summary[b]					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.355[a]	.126	.091	.04807	2,042
a. Predictors: (Constant), LAG_X2, LAG_X1					
b. Dependent Variable: LAG_Y					

Source: Output SPSS v.25

The results of the autocorrelation test using the *cochrane-orcutt* are shown in table 5. From the test results with k (2) and N (55) at 5% significance, the Durbin-Watson table value distribution is equal to 2,042. This value lies between the dU value of 1.6406 and the 4-dU value of 2.3594. So the data in this study did not show signs of autocorrelation.

Table 6. ANOVA

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.048	2	.024	6,931	.002[b]
	Residual	.180	52	0.003		
	Total	.228	54			
a. Dependent Variable: ConAcc						
b. Predictors: (Constant), Own, CovMix						

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Source: SPSS v.25

Output Multiple Linear Test Results

F Test

Based on the F test that has been carried out in table 6, the sig value is obtained. of 0.02, the value is smaller than 0.05. Then for $F_{calculated}$ obtained a value of 6.931. This value is greater than the F_{table} of 3.17. So simultaneously the CovMix and Own variables affect ConAcc.

T-test

The results of the T-test are presented in table 3. From the tests carried out, a significance value of 0.921 for CovMix and 0.001 for Own was obtained. Then seen from the value of t_{count} the result is -0.099 for CovMix and 3.700 for Own. So from these results, the CovMix variable has no effect on ConAcc while Own has no effect on ConAcc. This is indicated by the significance value of CovMix which is greater than 0.05 and the value of t_{count} smaller than the t_{table} obtained by 2.004.

Effect *debt covenants* on accounting conservatism

Based on the results of the tests that have been carried out, *debt covenants* measured using *performance covenants* have no effect on accounting conservatism. This is indicated by a significance value of 0.921. This value is greater than 0.05 so that the hypothesis is rejected. This result is different from the research of Christensen & Nikolaev (2012), which found significant results between the use of *performance covenants* and conservatism. However, it supports the research of Retnaningtyas (2016), which found that the results had no effect between *debt covenants* and accounting conservatism. In positive accounting theory, *debt covenants* are considered to be able to overcome agency problems by limiting management behavior. In explaining it Christensen & Nikolaev (2012), divides debt covenants into *performance covenants* and *capital covenants*.

Performance covenants depend on profitability and efficiency indicators which are formulated in the form of income statement information or in combination with balance sheet data. Therefore, *the performance covenant* has the nature of timeliness. This makes the use of *performance covenants* to act as triggers that facilitate *lenders* in limiting managerial actions when performance is considered poor.

Capital covenants function as aligning interests between *debtholders* and *shareholders*. This can happen by requiring *shareholders* to maintain sufficient capital in the company. *Capital covenants* are very dependent on the source and use of capital so as to limit debt to the capital structure. According to Christensen & Nikolaev (2012), *capital covenants* intervention *debtholder*.
In this study, the results obtained that *performance covenants* have no effect on accounting conservatism. According to Retnaningtyas (2016), this can happen because managers try to avoid

covenant violations. Based on the *debt covenant*, the higher the debt-to-equity ratio, the more likely managers are to use accounting methods that can increase income. In addition, firms with high *leverage* are more likely to be constrained by debt covenants. Debt agreements can indicate that the company cannot pay dividends if retained earnings fall below a certain level. As a result, companies will tend to choose accounting methods that will increase net income (Kieso, Weygandt, & Warfield, 2013:1365). This is because dividend payments can transfer wealth from *debt holders* to *shareholders* by reducing available assets to meet *debt holders* , thereby increasing the risk of default. In an effort to avoid violating debt covenants, companies with *leverage* may behave opportunistically. This is based on the behavior of managers who want to impress lenders that the company is in good condition (Iatridis, 2011).

Effect of managerial ownership on accounting conservatism

From the results of the tests that have been carried out, managerial ownership has a positive effect on accounting conservatism. This is indicated by a significance value of 0.001 so that the hypothesis is accepted. Thus, the results obtained support the statement on agency theory. Agency problems arise due to the separation between ownership and control. Managers are the main source of information about the actual condition of the company's performance. This results in asymmetric information between *agents* with *principals*. Managers with a limited view will try to transfer wealth for themselves so that they can distract managers from creating value for shareholders (Lafond and Roychowdhury, 2008).

This is because management compensation includes bonuses that are determined based on performance. So in achieving his desire to get bonuses, managers will tend to use accounting methods that can increase profits (Watts & Zimmerman, 1990). Opportunistic management actions by increasing profits are considered non-conservative and can trigger agency problems. According to Jensen & Meckling (1979), in the agency relationship there is no possible relationship between the *principal* and the *agent* that exists without any costs (*zero cost*). So in order to align interests, managers are given incentives in the form of managerial ownership which results in managers also feeling that they own the company being managed so that financial statements become more conservative. The results of this study support the results of Lafond & Roychowdhury (2008) and Pratanda & Kusmuriyanto (2014), which found the results have a positive effect between managerial ownership and conservatism.

CONCLUSION

Agency problems arise due to the separation between ownership and control. Managers are the main source of information about the actual condition of the company's performance. This results in asymmetric information between *agents* with *principals*. With the asymmetric information, it causes *moral hazard* to the agent. So with managerial ownership, the director is also an agent of the shareholders with fiduciary responsibility. So ownership can provide incentives for directors to monitor the company and reduce the need for conservative financial reports (Lafond and Roychowdhury, 2008). However, managers with high shareholding tend to be undisciplined when they engage in actions that serve their own interests but conflict with the interests of shareholders. So to answer these problems, external supervision is needed.

Fama (1985), found that lenders have a comparative advantage in minimizing information costs and gaining access to information that is not publicly available (Florackis, 2008). Based on the *debt covenant*, the higher the level of debt ratio, the more likely it is for managers to use methods that can increase net income with the aim of avoiding *debt covenant* (Kieso et al., 2013:1365; Kim, 2019). In overcoming these problems, there has been a demand to make conservative financial reports. According to Christensen & Nikolaev (2012), *financial covenants* can control conflicts of interest between *lenders* and *borrowers* through two different mechanisms. First, *capital covenants* can overcome agency problems by aligning the interests of *debtholders* with *shareholders* through equity requirements. Both *financial covenants* function as triggers that limit agency problems through the transfer of control to *debtholders* if performance falls below the required level.

n this study, there are limitations, namely, the test only focuses on one industrial sector. Second, observations were only made in the 2015-2019 range. The three measurements on each variable were only tested using one measuring instrument. Suggestions for further research is to conduct tests using different measurements to find out more comprehensive results. Tests for other industrial sectors and additional years of observation are also needed to obtain broader results.

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