

Debt Covenant, Capital Intensity, and Accounting Prudence: Moderating Role of Litigation Risk

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ABSTRACT

Purpose of research is to analyze (1) effect of debt covenants also capital intensity on accounting prudence. (2) Whether litigation risk moderates effect of debt covenants also capital intensity on accounting prudence. Conducted using secondary data, specifically quantitative data obtained from financial statements of non-financial consumer goods sector companies listed on BEI during period 2023-2024, resulting in a total sample of 210 observations using multiple linear regression analysis. Results of research indicate debt covenants also capital intensity have significant on accounting prudence. Litigation risk was found to moderate relationship between debt covenants also accounting prudence, suggesting that higher litigation risk encourages implementation of more cautious accounting practices. Company size also growth opportunities are used to control company characteristics that influence financial reporting behavior. Empirical results in form of factors that affect accounting conservatism within framework of agency theory also positive accounting theory. This moderation falls under type of Pseudo Moderator Variable, which is a variable that mediates relationship between dependent also independent variables. Litigation Risk cannot significantly moderate relationship between Capital Intensity also Accounting Conservatism.

INTRODUCTION

The central research problem addressed in this study concerns the determinants of accounting prudence (conservatism) in non-financial consumer goods companies listed on the Indonesia Stock Exchange (IDX): specifically, whether debt covenants and capital intensity—two principal contractual and structural drivers identified in the accounting conservatism literature—exert significant effects on firms' conservative financial reporting behavior, and whether litigation risk meaningfully moderates these relationships. Despite the growing body of Indonesian accounting research, prior studies have not simultaneously examined the joint

moderating role of litigation risk on both the debt covenant–prudence and capital intensity–prudence relationships within a unified moderated regression framework. Moreover, existing evidence is predominantly drawn from manufacturing or multi-sector samples and rarely employs an accrual-based continuous measure (CONACC) of prudence combined with interaction-term moderation testing, leaving a significant gap in understanding how legal exposure conditions conservative reporting in the sector-specific context of Indonesian consumer goods firms. Addressing this gap is theoretically important because it extends Agency Theory and Positive Accounting Theory to a less-studied sector and empirically important because it provides actionable evidence for creditors, investors, and regulators who rely on the quality and reliability of financial reporting.

Prudence is one of concepts that developed into an accounting principle, also referred to as caution, or "prudence" is one of concepts that eventually became an accounting principle. After IFRS convergence, term "prudence" was replaced by "conservatism." The principle of accounting application is used differently to ensure that financial statements of global companies comply with same standards, will recognized in other countries (Sinta, 2016). Revenue that is still in potential form can be recognized based on IFRS prudence principle if revenue recognition requirements are met, while still applying prudence principle in recognition. According to Baker and Persson (2021), prudence has become an important moral virtue and a component of commercial and accounting practice throughout history, even though accounting standard setters have now relegated it to a secondary level of importance. Baker, 2015 (in Šestanji-Perić & Kozjak, 2020) in IASB ED/2015/3 Exposure Draft stated that prudence is defined as " application of a higher verification threshold for recognition of assets or income than for liabilities or losses." If revenue and assets are treated differently from expenses and liabilities, IASB refers to this as 'asymmetric prudence,' but this term is not mentioned in revised CF as a concept that can produce useful financial information.

PSAK uses principle of prudence in Conceptual Framework for Preparing and Presenting Financial Statements to address uncertainty of certain events and circumstances, including estimating useful life of equipment and supplies, claims for potential warranties, and collectibility of doubtful receivables which is essential in ensuring the credibility of financial reporting for stakeholders (Kamil et al., 2023). When making estimates in uncertain situations, principle of prudence requires that assets aren't overstated also liabilities aren't understated. Prudence approach prohibits creating unrecorded reserves or excessive provisions, as well as deliberately reducing assets or income or increasing liabilities and expenses. The principle of prudence uses present value as an indicator to measure financial statements that are relevant, easily understood, reliable, and comparable. Leverage (debt contracts) is a key factor that can influence application of prudence principle in accounting. Sirait et al. (2023) explain leverage as an indicator for assessing a company's tendency to default on debt contracts and showing that company's assets are under debt. High-yield debt, including leveraged loans, is characterized by financial covenants, or "cov-lite" provisions. Traditional loan agreements include maintenance covenants, requiring ongoing compliance with covenant thresholds, and violations that shift control rights to lenders. Existing agreements maintain control rights but trigger predetermined incentives to take lending actions once covenant thresholds are breached (Bräuning et al., 2022).

A debt contract is an agreement aimed at imposing restrictions on a company by creditors to minimize defects in loan value and its recovery. Additional reward programs

offered by companies to their employees serve as incentives to achieve certain goals or improve performance. The higher manager's performance, more rewards they will receive in form of bonuses (Karampour, 2021). These two main factors can influence principle of prudence. The second factor affecting accounting prudence is capital intensity, in which large companies have higher profits and more complex management systems. This creates more complex risks and issues in large companies compared to small companies because their high profits tend to be permanent, thereby making taxes and public services potentially subject to higher demands by government and possible political costs. A solution to cut political costs is usually for companies to implement savings. Thus, higher capital intensity, larger assets needed; therefore, principle of prudence will be applied by company (Azizah et al., 2022). The second factor mentioned among main factors can affect principle of prudence. The third factor that can moderate application of cautious accounting is Litigation Risk, which is a risk coming from third parties aiming to harm company for their own interests. When faced with legal claims, litigation risk has potential to incur significant costs. Rationally, management will avoid legal losses through careful reporting, as high profits increased likelihood of litigation (Abbas et al., 2021). When a company generates a lot of money and pays high dividends while settling debts, risk of litigation will increase.

Despite growing scholarly interest in accounting conservatism, several critical research gaps remain inadequately addressed. First, most prior studies have examined debt covenants and capital intensity as independent drivers of accounting prudence in isolation, without simultaneously testing the moderating role of litigation risk on both relationships (Abbas et al., 2021; Azizah et al., 2022). Second, the majority of existing evidence is drawn from manufacturing or multi-sector samples in developed economies, leaving the specific dynamics of consumer goods companies listed on the Indonesia Stock Exchange (IDX) — a context characterized by high informational asymmetry and evolving regulatory standards — largely unexplored (Nur et al., 2023). Third, the operationalization of accounting prudence as a continuous accrual-based measure (CONACC), rather than a binary proxy, has rarely been combined with interaction-term moderation testing in the Indonesian context (Murwaningsari & Rachmawati, 2017). These gaps collectively weaken the theoretical and practical foundations available to creditors, investors, and regulators seeking to understand the determinants of prudent financial reporting in emerging markets. The present study therefore addresses four specific research problems: (1) whether debt covenants significantly influence accounting prudence in consumer goods firms; (2) whether capital intensity significantly influences accounting prudence; (3) whether litigation risk directly affects accounting prudence; and (4) whether litigation risk moderates the relationships between the two independent variables and accounting prudence. Accordingly, this study is guided by the following explicit research objectives: (1) To analyze the effect of debt covenants on accounting prudence in non-financial consumer goods companies listed on BEI for the period 2023–2024; (2) To analyze the effect of capital intensity on accounting prudence in those companies; (3) To analyze the direct effect of litigation risk on accounting prudence; (4) To test whether litigation risk moderates the relationship between debt covenants and accounting prudence; and (5) To test whether litigation risk moderates the relationship between capital intensity and accounting prudence. By addressing these objectives within the joint framework of Agency Theory and Positive Accounting Theory, this study is expected to

contribute empirically to financial accounting scholarship and to provide practical implications for stakeholders concerned with the quality and reliability of financial reporting.

Agency Theory

This theory was initially proposed Jensen and Meckling (1976), which explains how corporate governance is influenced by conflicts of interest shareholders, managers, also creditors. It describes relationship where principals delegate authority in decision-making to agents. This can result in agents not acting in best interest of principals when there is a utility-maximizing relationship between parties. Based on agency theory, intensity of capital and debt covenants are instruments that can be used to reduce information asymmetry and address potential conflicts. Accounting prudence can serve as a response to shareholders' desire to reduce agency risks that may be detrimental to them. Accounting prudence can arise as a response to management's need to ensure achievement of performance targets that qualify for bonuses. A debt covenant is a contractual agreement between a company and its creditors. Agency theory highlights that companies have an incentive to comply with these agreements to maintain good relationships with creditors. Accounting prudence can be used to mitigate risk of covenant violations as well as to maintain creditor trust, while also considering role of institutional ownership as a moderator in relationship between owners and agents. Institutional ownership can influence how a company responds to capital intensity, debt covenants, and implementation of accounting conservatism.

Positive Accounting Theory

Positive accounting theory is defined as scientific reasoning or explanation regarding the accuracy of accounting reports or phenomena in accordance with the facts by Inanga and Schneider (2005). Furthermore, according to Watts and Zimmerman (1986), positive accounting theory is a theory that can predict the accounting policies a company will choose under certain conditions and explain why accounting policies become problematic for companies and parties interested in financial statements. Positive theory helps describe and explain accounting practices that actually occur within companies. In this context, it can be identified whether companies tend to apply accounting prudence in response to debt covenants and capital intensity. With a positive approach, attention can be focused on how the Political Cost Hypothesis, applied through capital intensity, can influence accounting policy. Watts and Zimmerman (1990) describe 3 hypotheses in accounting: 1. Bonus plan hypothesis, 2. Debt covenant hypothesis, 3. Political cost hypothesis.

Hypothesis Development

H1: Debt covenant has a positive effect on accounting prudence

According to debt covenant hypothesis, which is part of Watts and Zimmerman (1990) explanation regarding concept of positive accounting, company managers, in order to avoid defaulting on debt agreements, implement strategies that will boost profits as company approaches such agreements. Managers will strive to avoid failure in loan arrangements by using accounting practices that align with their interests, such as carrying forward profits from each period. This condition indicates that likelihood of a business being able to implement practices that increase reported profits will rise along with level of debt covenants. The study

by Ramadhani and Sulistyowati (2019) states that to reduce political costs, companies are very cautious in their financial reporting, especially in recording profits.

H2: Capital intensity has a positive effect on accounting prudence.

According to positive accounting theory, companies that are growing usually report their profits conservatively in order to reduce political risk and high costs. Serves as a solution to avoid scrutiny from securities analysts and regulators. Internal or external parties of company desire profitable growth. High company profits are reflected in future company growth, indicating that company is becoming more conservative. In this theory, companies strive to reduce political costs so that their profits are maximized. Taxes are considered a political cost for company, so management attempts to report lower profits to avoid high taxes (Azizah et al., 2022).

H3: Litigation risk has a positive influence on accounting prudence.

Litigation risk can encourage companies to adopt a conservative approach in recognizing revenues and expenses. The principles of prudence in accounting can also prompt companies to implement more proactive litigation risk management policies. Litigation risk can impact principles of accounting prudence by encouraging companies to take a more conservative approach in recognition, estimation, and disclosure of financial information (Nur et al., 2023).

H4: Litigation risk moderates effect of debt covenants on accounting prudence.

The relationship between accounting prudence also debt covenants can strengthened through litigation risk. When litigation risk increases, companies tend to adopt more conservative approach in accounting to minimize potential legal risks associated with violating debt covenants. High litigation risk can make companies more sensitive to provisions in debt covenants, which in turn can strengthen or weaken their impact on conservative accounting practices (El-habashy, 2019).

H5: Litigation risk moderates effect of capital intensity on accounting prudence.

If a company faces a lawsuit, it will damage company's reputation, impacts decline in company's stock value. In addition, company will incur high costs as a result of lawsuit, such as costs for breaching contracts and restoring company's reputation. When this happens, company is considered to have committed public fraud, and interested parties will sue company. The study by Rahayu et al. (2018) shows that interested parties have legal protection as fund owners. Research by Ma et al. (2020) indicates that companies with these characteristics require more conservative accounting policies to avoid lawsuits and agency conflicts. Therefore, higher litigation risk, greater capital intensity and impact of litigation on accounting conservatism. Therefore, it is suspected that risk of litigation can be used to reduce profits in situations where risk of litigation poses a higher risk.

METHOD

This study adopts a quantitative research design using secondary data sourced from audited annual financial statements. The research procedure was carried out systematically through the following stages: (1) Research Design — a quantitative, explanatory approach was

adopted to test causal relationships among the study variables based on hypotheses derived from Agency Theory and Positive Accounting Theory; (2) Population and Sampling — the population comprised all non-financial consumer goods sector companies (both primary and non-primary subsectors) listed on the Indonesia Stock Exchange (IDX) during 2023–2024. Purposive sampling was applied with the following criteria: (a) the company was continuously listed on IDX throughout 2023–2024; (b) the company published complete, audited financial statements for both fiscal years; and (c) all data required to construct the study variables were available. After applying these criteria, a total of 105 companies were retained, yielding 210 firm-year observations; (3) Data Collection — financial statement data were retrieved from the IDX official website (idx.co.id) and the companies' investor-relations portals. Variables were computed manually from balance sheets, income statements, and cash flow statements; (4) Variable Operationalization — each variable was operationalized using established proxies from the literature, as detailed in the Variable Definition section below; (5) Data Analysis — the collected panel data were processed using R Studio software (version 2025), and multiple linear regression analysis was employed to test the main effects and moderation hypotheses; (6) Assumption Testing — prior to hypothesis testing, the data were subjected to normality (Yeo-Johnson power transformation), multicollinearity (Variance Inflation Factor), heteroscedasticity (Glejser test), and autocorrelation (Durbin-Watson test) diagnostics to ensure the reliability of the regression estimates.

DEFINITION AND MEASUREMENT OF VARIABLES

Dependent Variable

Accounting Prudence (CONACC)

Accounting prudence (also termed conservatism) is the tendency of a firm to recognize losses and liabilities more quickly than gains and assets, thereby producing downward-biased accruals (Watts, 2003). Following Wati (2019), this study operationalizes accounting prudence using an accrual-based continuous measure (CONACC), calculated as the difference between net income plus depreciation and operating cash flow, scaled by total assets. A negative (more negative) CONACC value indicates higher prudence, reflecting that accruals are systematically downward. The formula is:

$$CONACC = \frac{NI + DEP - CFO}{TA} \times -1$$

Independent Variables

Debt Covenant (DC)

Debt covenants refer to contractual restrictions imposed by creditors on a borrowing firm to protect the value of their claims and minimize the risk of debtor opportunism (Jensen & Meckling, 1976). In the accounting conservatism literature, leverage — measured by the Debt-to-Asset Ratio (DAR) — is the standard proxy for the tightness of debt covenants, reflecting the proportion of assets financed by total liabilities (Jao & Ho, 2019; Solichah & Fachrurrozie, 2019). A higher DAR signals greater proximity to covenant thresholds, which under the Debt Covenant Hypothesis (Watts & Zimmerman, 1990) incentivizes managers to adopt income-increasing, or conversely, prudent recognition strategies. This study measures DC using the following formula (Rachmawati & Suprihadi, 2021):

$$DER = \frac{Total\ Debt}{Total\ Assets}$$

Capital Intensity (IM)

Capital intensity measures the degree to which a firm relies on fixed and total assets to generate revenue, and serves as an indicator of the political costs associated with large capital bases (Watts & Zimmerman, 1990). Firms with high capital intensity tend to attract regulatory scrutiny and bear higher political costs, motivating management to adopt conservative accounting policies that reduce reported profits (Azizah et al., 2022; Murwaningsari & Rachmawati, 2017). Capital intensity is operationalized as the ratio of total assets to total sales, consistent with prior Indonesian studies (Rivandi & Ariska, 2019; Saragih et al., 2022). A higher ratio signals greater asset deployment per unit of revenue, reflecting deeper capital embeddedness. The measurement formula is as follows (Murwaningsari & Rachmawati, 2017):

$$IM = \frac{\text{Total Assets}}{\text{Sales}}$$

Moderating Variable

Litigation Risk

Litigation risk refers to the probability that a firm will face legal action from creditors, investors, employees, regulators, or other third parties as a consequence of its financial reporting and business decisions (Abbas et al., 2021; El-habashy, 2019). High litigation exposure creates incentives for management to adopt conservative recognition and disclosure policies, since prudent financial reporting reduces the evidentiary basis for legal claims related to earnings manipulation or asset overstatement (Nur et al., 2023). Following Abbas et al. (2021) and Tatar and Sujana (2021), this study operationalizes litigation risk as the ratio of net working capital (current assets minus current liabilities) scaled by total assets. A lower or negative ratio signals that the firm is operating with thin liquidity buffers, heightening the probability that creditors or investors will initiate legal claims. This proxy captures the short-term financial vulnerability dimension of litigation exposure and is consistent with the formula applied in the Indonesian accounting conservatism literature. The formula is:

$$RL = \frac{\text{short-term assets} - \text{short-term liabilities}}{\text{Total Assets}}$$

Control Variables

Company Size

This variable refers to level of a company in terms of its total assets. Creditors tend to find it easier to lend funds to large companies. Company size affects taxes and political costs, which lead companies to apply conservative accounting principles. The formula for calculating company size is determined through natural logarithm of total assets (Wati, 2019; Yulianti & Rachmawati, 2019).

$$\text{Company Size} = \text{Total Assets (natural log)}$$

Growth Opportunity

Opportunities for a company to grow and develop are referred to as Growth Opportunities. To achieve company growth, to apply accounting conservatism that can be well-received by investors and potential investors, which can create goodwill. This asset is created due to high company growth, motivating it to tend to show lower profits. Lower

profits will influence market price to be higher than its book value. This indicates that a company can earn profits from assets it owns (Karantika & Sulistyawati, 2018).

$$\text{Market to Book Value} = \frac{\text{Closing Price per} - \text{share}}{\text{book value per} - \text{share}}$$

Data Analysis Method

Multiple linear regression analysis was selected as the primary analytical tool for three reasons. First, the research model involves more than two independent variables (debt covenants, capital intensity, and litigation risk) alongside two interaction terms and two control variables, making multiple regression the appropriate technique for simultaneously estimating the partial and combined effects of these predictors on accounting prudence (Hair et al., 2019). Second, the dependent variable (CONACC) is a continuous accrual-based metric, satisfying the scale-of-measurement requirement for ordinary least squares (OLS) estimation. Third, this approach is consistent with prior studies on accounting conservatism that have employed moderated multiple regression (MMR) to test the incremental explanatory power of moderating variables through product-term interactions (Hajawiyah et al., 2020; Saragih et al., 2022). Moderation is assessed by introducing interaction terms (DC×RL and IM×RL) into the regression equation; a statistically significant interaction coefficient indicates that litigation risk strengthens or weakens the relationship between the respective predictor and accounting prudence. Two control variables — Company Size (SIZE) and Growth Opportunity (GROWTH) — are included to isolate the effects of firm-specific characteristics that prior literature has consistently shown to influence accounting conservatism (Wati, 2019; Yulianti & Rachmawati, 2019). The complete regression equation estimated in this study is:

$$\text{CONACC} = \alpha + \beta_1\text{DC} + \beta_2\text{IM} + \beta_3\text{RL} + \beta_4(\text{RL}*\text{DC}) + \beta_5(\text{RL}*\text{IM}) + \beta_6\text{SIZE} + \beta_7\text{GROWTH} + \varepsilon$$

Information:

CONACC	= Accounting Prudence
DC	= Debt Covenant
IM	= Capital Intensity
RL	= Litigation Risk
SIZE	= Company Size
Growth	= Growth
α	= Constant
ε	= Error
β	= Regression Coefficient

RESULT AND DISCUSSION

Descriptive Analysis

To provide description research variables. It is carried out through statistical measures such as standard deviation, mean (average value), highest and lowest values.:

Tabel 1. Descriptive Statistics

Variabel	N	Min	Max	Mean	SD
CONACC	210	-10.849	1.883	-0.049	0.008
DC	210	0.003	1.835	0.451	0.632

IM	210	0.003	1.722	0.013	0.473
RL	210	-1.489	0.929	0.129	0.385
SIZE	210	22.937	36.874	28.321	29.560
GROWTH	210	-15.976	0.993	0.096	0.351

Source: Output Rstudio, 2025

Normality Test

Determine normality assumption for each variable. This method uses power transformation to map original data into a new distribution, with power being a parameter estimated from data Almujaally et al. (2024).

Tabel 2. yjPower Transformation

yjPower Transformation to Normality	
Est Power	0.331
Wald Lowerr Bond	0.318
Wald Upperr Bond	0.345
LR test	0
p-value	0.00

Source: Output Rstudio, 2025

Normality test results indicate that transformation applied (yjPower Transformation) using a transformation power of approximately 0.331 has produced a data distribution that is close to normal. This is reflected by confidence interval for transformation power (0.318 - 0.345), which shows that this estimate is fairly accurate.

Additionally, results of likelihood ratio test indicate evidence that transformation parameter (lambda) is equal to 0. The extremely small p-value (0.000) indicates transformation applied is statistically significant in improving normality of data. The procedure carried out has successfully made data approach a normal distribution.

Table 3. t-Test Results (Individual Test)

$$CONACC = 0.108 + 0.179DC + 0.074IM + 0.366RL - 0.383*RL - 0.251*RL - 0.010SIZE - 0.009GROWTH$$

Variable	Predictions	Coefficient	Prob	Collinearity	
				Tolerance	VIF
C		0.108	0.777		
DC	+	0.179	0.078	0.464	1.041
IM	+	0.074	0.416	0.173	1.414
RL	+	0.366	0.004**	0.193	2.930
DC*RL	+	-0.383	0.080	0.007	1.207
IM*RL	+	-0.251	0.410	0.206	1.716
SIZE	+	-0.010	0.457	0.904	1.029
GROWTH	+	-0.009	0.740	0.329	1.015
R2		0.028			
Adj R2		0.011			
F stat		1.668			
Durbin Watson		0.165			
Glacier Test		0.066			
Observation		210			

*Note: DC: Debt Convernant; IM: Capital Intensity; RL: Litigation Risk; DC*RL: Debt Convernant*Litigation Risk; IM*RL: Capital Intensity*Litigation Risk; SIZE: Company Size; GROWTH: Growth Opportunity.*

Source: Output Rstudio, 2025

The table 3 shows:

This can be seen from the low Multiple R-squared value of only around 0.028, indicating that only around 2.78% of the variation in the dependent variable can be explained by the model. As shown above, Adj R² is 0.011, which means that the ability of the independent variable to explain the dependent variable is 1,1%. The F test yielded a p-value of 0.115, greater than the research significance value of 0.05, and an F-stat value of 1.668 > F table of 4.375, indicating that the regression model used did not provide a strong explanation of the variation in the data. The Glacier test results indicate that in this model, the significance value for all variables in this study is greater than 0.05 (5%), thus it can be concluded that the assumption of homoskedasticity is met. The Durbin Watson test produces a p-value greater than the significant value of 0.165 > 0.05 so it can be said that there is no autocorrelation in the research variables.

The Debt Convenience variable provides a parameter coefficient of 0.179 with a significance level of 0.078 (<0.1) at a 10% significance level. The p-value of 0.078 < 0.1 indicates that Debt Convenience partially influences Accounting Prudence. The Capital Intensity variable provides a parameter coefficient of 0.074 with a significance level of 0.416 (<0.1) at a 10% significance level. The p-value of 0.416 < 0.1 indicates that Capital Intensity has no partial effect on Accounting Prudence. The Litigation Risk variable, as a moderating variable, provides a parameter coefficient of 0.366 with a significance level of 0.004 < 0.05. Moderating variable I, the interaction between Debt Conformity and Litigation Risk, yields a parameter coefficient of -0.383 with a significance level of 0.080 (<0.1) at a 10% significance level. The significance value of moderating variable I is 0.080 < 0.1, thus concluding that the moderating variable Litigation Risk can moderate the relationship between Debt Conformity and Accounting Prudence. Moderating variable II, the interaction between Capital Intensity and Litigation Risk, yields a parameter coefficient of -0.251 with a significance level of 0.410 (>0.1) at a 10% significance level. The significance value of moderating variable II is 0.410 > 0.1, thus concluding that the moderating variable Litigation Risk cannot moderate the relationship between Capital Intensity and Accounting Prudence.

DISCUSSION

The following discussion interprets each empirical finding in light of the underpinning theoretical frameworks — Agency Theory (Jensen & Meckling, 1976) and Positive Accounting Theory (Watts & Zimmerman, 1986) — and situates the results within the existing body of literature on accounting conservatism and prudence.

The Effect of Debt Covenants on Accounting Prudence (H1 Supported)

The finding that debt covenants exert a significant positive effect on accounting prudence ($\beta=0.179$, $p=0.078$) is consistent with the Debt Covenant Hypothesis of Positive Accounting Theory (Watts & Zimmerman, 1986, 1990), which posits that as a firm approaches covenant thresholds, managers adopt accounting strategies that reduce the probability of technical default. From an Agency Theory perspective (Jensen & Meckling, 1976), debt

contracts serve as monitoring mechanisms that principals (creditors) impose on agents (managers) to protect the value of their claims; accounting prudence is therefore an endogenous response by management to maintain creditor confidence and avoid the loss of control rights that covenant violation would entail (Bräuning et al., 2022). This result corroborates the findings of Jao and Ho (2019), who documented a positive association between debt covenants (leveraged using the DAR proxy) and accounting conservatism in Indonesian manufacturing firms, and of Sea and Noor (2022), whose multi-sector study confirmed that higher leverage ratios encourage more conservative recognition of assets and liabilities. Conversely, the finding contrasts with Hajawiyah et al. (2020), who reported insignificant effects, a discrepancy attributable to differences in sample composition and the inclusion of corporate governance mechanisms as additional controls. The practical implication is that creditors operating in the IDX consumer goods sector can rely on leverage ratios as leading indicators of conservative reporting behavior, which in turn reinforces the informational quality of financial statements used in credit risk assessments.

The Effect of Capital Intensity on Accounting Prudence (H2 Not Supported)

The result that capital intensity does not significantly influence accounting prudence ($\beta=0.074$, $p=0.416$) diverges from the Political Cost Hypothesis of Positive Accounting Theory (Watts & Zimmerman, 1990), which predicts that firms with large asset bases face higher political scrutiny and therefore adopt more conservative accounting to reduce the visibility of profits. Although the directional sign of the coefficient is positive and consistent with the hypothesis, the lack of statistical significance suggests that, within the consumer goods sector during 2023–2024, the magnitude of capital investment does not independently drive prudent reporting decisions. This finding is consistent with the results of Kurniawan et al. (2022) and Rivandi and Ariska (2019), both of whom found insignificant associations between capital intensity and conservatism in Indonesian samples, attributing the result to the tendency of capital-intensive firms to prioritize profit maximization and investor signaling over conservative recognition policies. In contrast, Murwaningsari and Rachmawati (2017) and Saragih et al. (2022) documented significant positive effects in broader multi-sector samples, indicating that sector composition and sample period may moderate the strength of this relationship. From an Agency Theory standpoint, the absence of a significant effect may reflect the dominance of shareholders' demands for reported profitability in the consumer goods sector, which can override the conservative impulse that high capital intensity would otherwise generate. This result implies that capital intensity alone should not be used as a singular predictor of prudence in sector-specific financial statement analyses; future research should incorporate leverage and ownership structure as joint moderators to better capture the contextual conditions under which capital intensity influences reporting choices.

The Direct Effect of Litigation Risk on Accounting Prudence (H3 Supported)

Litigation risk exerts the strongest direct effect on accounting prudence among all independent variables in the model ($\beta=0.366$, $p=0.004$), which is statistically significant at the 1% level. This finding is strongly aligned with the theoretical prediction of Agency Theory (Jensen & Meckling, 1976): when the threat of third-party litigation is high, management — acting in a self-protective capacity as agents — adopts conservative recognition and disclosure policies to reduce exposure to legal claims and to minimize the information asymmetry that

would otherwise make the firm a target for investor or creditor litigation (Abbas et al., 2021). From the Positive Accounting Theory perspective, this result is also consistent with the Political Cost Hypothesis, as high litigation risk constitutes an external cost that incentivizes managers to report lower profits and more prudent asset valuations (Watts & Zimmerman, 1990). The finding aligns with Nur et al. (2023), who systematically reviewed Indonesian evidence and concluded that litigation risk is among the most robust determinants of accounting conservatism, and with Abbas et al. (2021), who found a significant positive relationship between litigation risk (proxied by working-capital-to-total-assets) and conservatism in their cross-country sample. It also corroborates El-habashy (2019), who identified litigation risk as a governance-level attribute that amplifies conservative financial reporting in Egyptian listed companies. The finding contrasts with Tatar and Sujana (2021), who reported that litigation risk was insignificant after controlling for managerial ownership, suggesting that ownership structure may condition the litigation-prudence nexus. The practical implication is significant: companies in the Indonesian consumer goods sector facing higher litigation exposure — reflected in lower net working capital ratios — systematically apply more conservative accounting treatments, which provides a credible signal of financial caution to external stakeholders.

Moderating Effect of Litigation Risk on Debt Covenants – Accounting Prudence Relationship (H4 Supported)

The interaction term DC×RL yields a statistically significant coefficient ($\beta=-0.383$, $p=0.080$) at the 10% significance level, confirming that litigation risk moderates the relationship between debt covenants and accounting prudence. The negative sign of the interaction coefficient indicates that the moderation operates as a pseudo-moderator (also known as a suppressor moderator): while both debt covenants and litigation risk individually push firms toward conservatism, their joint effect attenuates the marginal contribution of debt covenants once litigation risk is already elevated. This is theoretically coherent under Agency Theory (Jensen & Meckling, 1976): when a firm simultaneously faces high contractual pressure from creditors and high legal exposure from third parties, the incremental incentive to be more conservative due to debt covenants is partially absorbed by the dominant effect of litigation risk, which already compels maximum prudence. Watts and Zimmerman (1990) Debt Covenant Hypothesis also implicitly supports this pattern — when multiple external pressures converge, the marginal impact of any single contracting variable diminishes as the firm has already adopted its optimal conservative reporting posture. This finding corroborates the moderating evidence reported by Abbas et al. (2021), who found that the debt covenant-conservatism association was conditioned by litigation exposure, and partially aligns with El-habashy (2019), who documented that legal-risk governance attributes reshape the debt-covenants-reporting nexus. The result extends prior Indonesian evidence by Jao and Ho (2019), who did not include litigation risk as a moderator, and thus provides a more complete picture of the contextual determinants of prudent reporting in leveraged consumer goods firms. The classification of this moderation as a Pseudo Moderator Variable is appropriate given that litigation risk is itself a significant predictor of accounting prudence (H3 supported), which is the defining criterion for this category of moderator (Arnold, 1982; Sharma et al., 1981).

Moderating Effect of Litigation Risk on Capital Intensity – Accounting Prudence Relationship (H5 Not Supported)

The interaction term $IM \times RL$ is not statistically significant ($\beta = -0.251$, $p = 0.410$), indicating that litigation risk does not meaningfully moderate the relationship between capital intensity and accounting prudence in this sample. This result is consistent with the baseline finding under H2, where capital intensity itself failed to exert a significant direct effect on prudence. When the main effect of a predictor is absent or weak, the theoretical basis for expecting its interaction with a moderator to be significant is substantially undermined (Baron & Kenny, 1986; Sharma et al., 1981). From a Positive Accounting Theory perspective (Watts & Zimmerman, 1990), the Political Cost Hypothesis predicts that capital-intensive firms would be more sensitive to external scrutiny and litigation threats; however, the evidence here suggests that within the specific context of consumer goods companies during 2023–2024, the political cost mechanism does not operate strongly enough to generate a detectable interaction. This may be attributed to several contextual factors. First, the consumer goods sector in Indonesia is characterized by relatively stable regulatory oversight compared to capital-heavy extractive industries, reducing the sensitivity of capital-intensive firms to litigation threats (Nur et al., 2023). Second, the working-capital-based proxy for litigation risk employed in this study primarily captures short-term liquidity exposure rather than the structural legal environment, which may be more directly relevant to the capital intensity-prudence nexus. Third, managerial discretion and firm-level corporate governance mechanisms — not captured in the regression model — may be the dominant shapers of how capital intensity translates into reporting behavior, a finding consistent with Hajawiyah et al. (2020) and Ma et al. (2020). The implication is that researchers and practitioners should not assume that litigation risk universally amplifies the conservatism-inducing effects of capital investment; the conditioning role of industry context, proxy selection, and corporate governance must be considered when interpreting moderation results.

CONCLUSION

This study examined the effects of debt covenants, capital intensity, and litigation risk on accounting prudence using a sample of 105 non-financial consumer goods companies listed on the Indonesia Stock Exchange (BEI) for the period 2023–2024, yielding 210 firm-year observations analyzed through moderated multiple regression ($CONACC = \alpha + \beta_1 DC + \beta_2 IM + \beta_3 RL + \beta_4 (RL \times DC) + \beta_5 (RL \times IM) + \beta_6 SIZE + \beta_7 GROWTH + \epsilon$). First, debt covenants exert a significant positive effect on accounting prudence ($\beta = 0.179$, $p = 0.078 < 0.10$), confirming H1 and supporting the Debt Covenant Hypothesis of Positive Accounting Theory; companies with higher leverage ratios are empirically shown to adopt more conservative reporting practices to avoid technical default. Second, capital intensity does not significantly influence accounting prudence ($\beta = 0.074$, $p = 0.416 > 0.10$), failing to support H2 and indicating that, within the consumer goods sector during 2023–2024, the political cost mechanism is insufficient to independently drive conservative recognition decisions. Third, litigation risk is confirmed as the strongest direct predictor of accounting prudence in the model ($\beta = 0.366$, $p = 0.004 < 0.01$), supporting H3 and demonstrating that companies facing greater legal exposure systematically apply more conservative accounting treatments in order to minimize evidentiary risks associated with potential legal claims. Fourth, litigation risk significantly moderates the relationship between debt covenants and accounting prudence ($\beta = -0.383$, p

= 0.080 < 0.10), supporting H4; the negative interaction coefficient classifies litigation risk as a Pseudo Moderator Variable, indicating that when litigation risk is already elevated, the marginal conservatism-inducing effect of debt covenants is attenuated because the firm has already adopted its optimal prudent reporting posture. Fifth, litigation risk does not significantly moderate the relationship between capital intensity and accounting prudence ($\beta = -0.251$, $p = 0.410 > 0.10$), thus H5 is not supported, consistent with the absence of a significant main effect for capital intensity in this sector-specific context.

Research Recommendations

Based on the findings and limitations of this study, several recommendations are offered for future research and practice. First, future studies should extend the observation period beyond two years and expand the sample to include multiple sectors—such as manufacturing, infrastructure, and financial services—to improve the generalizability of findings regarding the debt covenant–prudence and capital intensity–prudence relationships. Second, researchers are encouraged to incorporate additional moderating or mediating variables, such as institutional ownership concentration, board independence, and audit quality, which may condition the strength of the litigation risk–prudence nexus and provide a more complete theoretical picture within the Agency Theory framework. Third, alternative proxies for accounting prudence (e.g., market-based measures such as Basu’s asymmetric timeliness coefficient) and for litigation risk (e.g., industry-level litigation frequency or actual lawsuit records) should be tested alongside the CONACC and working-capital-ratio proxies used here to assess the robustness of results across operationalizations. Fourth, practitioners—including creditors, investors, and financial regulators—are advised to give greater weight to litigation risk indicators when evaluating the reliability of conservative reporting signals in the Indonesian consumer goods sector, as this study demonstrates that legal exposure is a more dominant driver of prudent reporting behavior than capital structure alone. Finally, standard-setters and policy makers should consider strengthening disclosure requirements related to litigation contingencies to enhance the transparency of financial reporting for stakeholders operating in emerging market environments characterized by high informational asymmetry.

Implications

This research for development of financial accounting research. Theoretically, findings of this study reinforce positive accounting theory regarding contractual factors and litigation risk, which play important role in encouraging application of accounting prudence. Practically, findings can serve as a reference for management, investors, also creditors in assessing quality of financial reporting, particularly concerning potential legal disputes and debt contract risk management. Furthermore, this study implies importance of regulations that can promote transparency and prudence in financial reporting to minimize conflicts of interest between company and its stakeholders.

Limitations and Future Research

Based on researcher's experience, study has several limitations. These limitations can serve as an important reference that future researchers need to consider to improve their research. The limitations include: Data may be incomplete or not cover all variables relevant

to study due to difficulty in accessing data or unavailability, The researcher doesn't have control over accuracy and quality of data from other researchers, which could pose a risk of errors in data and This study only focuses on certain variables and may overlook other factors that are also relevant and could affect research results.

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