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Accounting Conservatism in Times of Crisis: Examining the Effects of Financial Distress and Leverage on Corporate Financial Reporting

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ABSTRACT
Accounting conservatism has regained relevance amid global uncertainty, where firms increasingly face financial distress and complex debt structures. However, the extent to which financial distress and leverage affect this principle, and whether profitability moderates these relationships, remains a topic of debate. This study aims to examine the effect of financial distress and leverage on accounting conservatism, while testing the moderating role of profitability. A quantitative design was employed, using financial ratio analysis and panel data regression with a fixed-effect model. The sample comprises 20 food and beverage manufacturing firms listed on the Indonesia Stock Exchange from 2020 to 2023, selected through purposive sampling. Results show that financial distress negatively affects accounting conservatism, suggesting that firms under pressure tend to reduce prudence in order to maintain a favourable performance appearance. Conversely, leverage has a positive effect on conservatism, consistent with creditor monitoring that encourages timely recognition of losses. Profitability, however, neither directly affects conservatism nor moderates the relationship between distress or leverage and the level of conservatism. These findings suggest that profitability does not significantly Influence the impact of financial pressures on reporting practices. The study contributes to ongoing debates by clarifying the inconsistent evidence on the determinants of conservatism in emerging markets. Its implications suggest that regulators and creditors should prioritize monitoring leverage and distress factors rather than relying on profitability as a safeguard. Strengthening covenant structures and disclosure oversight is essential to ensure prudent reporting in financially constrained environments.

1. Introduction

In the midst of today's uncertain global economic dynamics, accounting conservatism has regained attention due to its critical role in preserving the quality of financial information under pressure (Balakrishnan et al., 2016). By recognising losses earlier while delaying the recognition of gains until realisation, conservatism is widely regarded as an adequate safeguard against earnings

manipulation (Biddle et al., 2022). Under conditions of financial distress and high leverage, conservative reporting serves as a contractual mechanism to protect the credibility of firms in the eyes of investors and creditors (Donovan et al., 2015). Nevertheless, empirical evidence suggests that managerial incentives to maintain the appearance of financial stability often encourage more aggressive reporting (Caskey & Laux, 2017), especially when weak governance and opportunistic interests dominate (Mohammed et al., 2017). Companies may even use conservatism selectively as a signalling device to portray illusory stability during crises (Dai & Ngo, 2021). Thus, conservatism should not be viewed merely as a technical accounting practice, but rather as a strategic phenomenon shaped by economic pressures and managerial discretion (Zhong & Li, 2017).

Financial reporting, as a medium of strategic communication, plays a decisive role in shaping market perceptions, particularly during periods of external volatility (Brennan & Merkl-Davies, 2018). Transparency is crucial for maintaining market confidence when firms encounter capital constraints and economic shocks (Lev, 2018). However, evidence shows that many firms exploit accounting flexibility to project an overly optimistic financial image (Al-Fasfus et al., 2022), which may ultimately threaten broader financial stability (Acharya & Ryan, 2016). The case of PT Garuda Indonesia (Persero) Tbk in 2019 illustrates such failure, where profit was reported from uncollected receivables, violating accounting standards and undermining prudence. This case highlights the importance of conservatism as a safeguard against misleading reporting (Ha, 2021). However, the financing structure has a significant impact on its effectiveness, as well as external pressures (Fariz et al., 2020), and managerial reporting strategies during distress (Hejranijamil et al., 2020). Contemporary scholarship, therefore, calls for a more nuanced evaluation of conservatism in complex financial environments (Guo et al., 2020).

Empirical evidence on the relationship between financial distress, leverage, and conservatism remains mixed. While some studies suggest that distress reduces conservatism as firms seek to avoid negative market signals and secure financing (Nguyen et al., 2022), others find that distress encourages more conservative reporting as a means to manage bankruptcy risk (Phuong Hong & Tra My, 2024). In this context, profitability is proposed as a moderating factor. Profitable firms may have more substantial incentives and greater capacity to apply conservatism, both to preserve credibility and to send positive signals of financial resilience (Khalilov & Osma, 2020; Kim et al., 2023). The signalling theory supports this perspective, suggesting that profitable firms use conservatism to communicate long-term strength, especially under high leverage (Lafond & Roychowdhury, 2008).

Nevertheless, prior findings on the moderating role of profitability are inconsistent, leaving an important gap in the literature. This study seeks to address this gap by empirically examining the effects of financial distress and leverage on accounting conservatism, while testing whether profitability moderates these relationships in the context of an increasingly uncertain economic environment.

Accounting Conservatism

Accounting conservatism is a key accounting principle that emphasises the earlier recognition of losses over gains, thereby producing more prudent and reliable financial statements (Ruch & Taylor, 2015; Xiao & Zhao, 2024; Zhong & Li, 2017). This principle reflects an asymmetry in the recognition of revenues and expenses, whereby losses are recognised immediately when indicators arise, whereas gains are recognised only when they are realised (Xiao & Zhao, 2024; Zadeh et al., 2022). This approach is often regarded as a protective mechanism for investors and creditors because it can minimise the risk of overstating assets or earnings (Biddle et al., 2022). In practice, accounting conservatism can reduce the cost of capital (Khalifa et al., 2019), enhance the quality of financial information, and improve corporate accountability, particularly when firms face uncertainty in their business environments.

Financial Distress and Accounting Conservatism

Accounting conservatism has long been regarded as a crucial mechanism for enhancing the quality of financial reporting and safeguarding stakeholder interests by recognising losses earlier than gains (Zadeh et al., 2022). Recent studies have confirmed that conservatism can reduce bankruptcy risk, enhance the credibility of financial reports, and improve creditor recovery (Al-Fasfus et al., 2022). However, financial pressures often drive management to reduce the application of conservatism in order to maintain the appearance of performance, making financial distress a significant determinant in lowering accounting conservatism (Papadaki & Pavlopoulou-Lelaki,

2022; Sun et al., 2023). While some studies highlight the benefits of conservatism in mitigating bankruptcy risk, others demonstrate that distress instead acts as a factor that diminishes conservatism (Phuong Hong & Tra My, 2024; Pujiono et al., 2023). This inconsistency reinforces the urgency of testing the following hypothesis:

H1: Financial distress negatively affects accounting conservatism.

Leverage and Accounting Conservatism

Leverage reflects the degree to which a company is dependent on debt-based financing (Djolafo, 2022), which directly increases the demands for transparency and accountability in financial reporting. To safeguard the interests of creditors, highly leveraged firms tend to adopt conservative accounting practices, namely recognising losses more quickly while delaying the recognition of gains (Atwa et al., 2022). Such conservatism serves as a contractual mechanism that reduces the risk of information asymmetry and ensures compliance with debt obligations (Ramalingegowda & Yu, 2021). Moreover, research shows that conservatism contributes to lowering the cost of capital and alleviating financial constraints under high-leverage conditions (Khalifa et al., 2019; Kim et al., 2023). To understand how capital structure, particularly leverage, drives firms to strengthen conservatism as a form of creditor protection and long-term financial stability, this study tests the following hypothesis.

H2: Leverage positively affects accounting conservatism

Profitability, Financial Distress, and Accounting Conservatism

Profitability reflects a company's ability to generate sustainable earnings, while also indicating financial stability and effective managerial performance. Firms with higher levels of profitability tend to possess greater flexibility in financial management and strategic decision-making, including in the application of accounting conservatism. Previous studies suggest that profitability may play a dual role: on the one hand, it increases managerial incentives to report more optimistically; on the other hand, it continues to encourage the application of conservatism as an accountability mechanism (Khalilov & Osma, 2020; Tang et al., 2021). Recent research further emphasises that financial characteristics such as profitability are important factors influencing the extent to which firms consistently apply conservatism (Phuong Hong & Tra My, 2024). Thus, in the context of financial distress, profitability has the potential to mitigate the negative impact of distress on conservatism, as adequate earnings can serve as a buffer that preserves commitment to more prudent reporting. To understand how the strength of corporate earnings can neutralise financial pressures that typically reduce conservatism, this study tests the following hypothesis,

H3: Profitability weakens the negative effect of financial distress on accounting conservatism.

Profitability, Leverage, and Accounting Conservatism

Profitability reflects a company's ability to generate earnings and serves as a key indicator of its financial health. Firms with high profitability tend to have greater financial flexibility to manage risks and sustain more prudent accounting practices. Research indicates that profitability is closely tied to the application of accounting conservatism, as profitable firms strive to maintain the credibility of their reports and safeguard stakeholder interests (Al-Fasfus et al., 2022; Khalilov & Osma, 2020). In the context of leverage, profitability plays a crucial role because firms with higher earnings have more substantial incentives to balance creditor demands with conservative reporting, thereby reducing the risk of information asymmetry (Phuong Hong & Tra My, 2024). Accordingly, profitability can strengthen the relationship between leverage and accounting conservatism, where leverage increases the need for conservatism, and profitability provides the capacity to maintain such practices consistently (Tang et al., 2021). To understand how the interaction between profitability and leverage shapes the practice of accounting conservatism, this study tests the following hypothesis.

H4: Profitability strengthens the positive effect of leverage on accounting conservatism.

2. Method

This study employs a quantitative method. The quantitative approach has proven effective in describing the phenomena observed in the research object, particularly those related to firm value in the food and beverage manufacturing sector during the period from 2020 to 2023. The research population comprises all manufacturing companies officially listed on the IDX in the food and beverage sector between 2020 and 2023, totalling 61 companies. The research sample was determined using purposive sampling. The following outlines the sampling procedure applied in this study.

Table 1 Sample Characteristics

No	Criteria	Number
1.	Manufacturing companies that have published annual reports for four consecutive periods, namely from 2020 to 2023.	61
2.	Companies operating in the food and beverage manufacturing sector.	(35)
3.	Companies that provide data containing the required information in financial statements and annual reports clearly and completely.	(15)
Total		**20**

Source: Data processed by researchers, 2025

The sample selection in this study was conducted using specific criteria to ensure the relevance and reliability of the data. First, the sample was limited to manufacturing companies that had consistently published annual reports for four consecutive periods, from 2020 to 2023, resulting in 61 firms meeting this requirement. Second, to maintain sectoral homogeneity, the focus was narrowed to companies operating in the food and beverage manufacturing sector, which reduced the sample to 35 firms. Third, the companies were further screened to include only those that provided complete and transparent information required in both financial statements and annual reports. Based on this final criterion, 15 firms were excluded due to incomplete disclosures. Consequently, the final sample used in this study comprised 20 companies that met all three criteria. This selection process ensures that the dataset is representative, consistent, and sufficiently comprehensive for empirical analysis.

This study involves three variables, namely the dependent variable, the independent variable, and the moderating variable. The dependent variable in this research is accounting conservatism, which is measured using the CONACC ratio as an indicator of accrual-based accounting conservatism. This ratio measures the difference between operating income and cash flows from operations as a percentage of total assets. A negative value reflects the firm's prudence in recognising earnings, whereas a positive value indicates a tendency toward more aggressive earnings reporting. Meanwhile, the independent variables in this study consist of two, namely leverage and financial distress. Leverage is calculated by assessing the ratio of total debt to total equity, which reflects the extent to which a firm utilises debt to finance its assets. Financial distress is measured using the Z-score, a tool employed to evaluate a firm's financial condition and identify the likelihood of bankruptcy. The Z-Score is calculated based on several key components, including working capital, EBIT, retained earnings, the market value of equity, and sales, all of which are divided by total assets.

Profitability in this study serves as the moderating variable and is measured using Return on Assets (ROA), which reflects a firm's ability to generate earnings from its assets. ROA serves as an indicator of a company's financial health and is used to convey positive signals to investors. In this context, profitability has the potential to influence the strength of the relationship between financial distress or leverage and accounting conservatism. This study aims to investigate the relationship between financial distress, leverage, and profitability, and the role of profitability in moderating the interaction between the independent and dependent variables, as well as the impact of accounting conservatism.

Data Analysis

In this research, data analysis was conducted using several tests, including model selection tests (Chow, Hausman, and *Lagrange Multiplier test*s), classical assumption tests, regression tests, and hypothesis tests. The process was carried out to analyse the interaction between independent variables, such as *financial distress* and *leverage*, with dependent variables in the form of accounting conservatism.

Regression Model:

$$AC = a + \beta_1 FD + \beta_2 LEV + \beta_3 PROF + \beta_4 (FD.PROF) + \beta_5 (LEV.PROF) + e$$

Description,

AC	= Accounting Conservatism (Dependent Variable).
β0	= Intercept
β1, β2, β3, β4, β5	= Slope regression
FD	= Financial distress (Independent Variable)
LEV	= *Leverage* (Independent Variable)
PROF	= Profitability (Independent Variable)
FD · PROF	= Interaction between *Financial Distress* and Profitability
LEV · PROF	= Interaction between *Leverage* and Profitability
ε	= Error

3. Results

Model Selection Analysis

To determine the most appropriate panel data estimation model, this study employed a series of specification tests, namely the Chow test and the Hausman test. These tests were conducted to determine which model— common effect, random effect, or fixed effect—best represents the data characteristics. The Chow test was first used to evaluate the suitability of the fixed-effects model compared to the random-effects model. Following this, the Hausman test was applied to distinguish between fixed-effects and random-effects specifications, thereby ensuring the robustness of the selected model for subsequent empirical analysis.

Table 2. Chow Test

Redundant Fixed Effects Tests Equation Untitled Test cross-section fixed effects			
Effects Test	Statistic	d.f.	Prob.
Cross-section F	5.401503	(19,55)	0.0000
Cross-section Chi-square	84.232657	19	0.0000

Source: Data processed by Eview 13, 2025

Based on the results presented in the Chow test in Table 2, the probability values of the Cross-Section F and Cross-Section Chi-square, which are lower than the significance level of 0.05, indicate that the selected model is the Fixed-Effect Model. Since the Chow test rejects the null hypothesis, the subsequent step is to conduct the Hausman test.

Table 3 Hausman Testing

Correlated Random Effects – Hausman Test Equation Untitled Test cross-section random effects			
Test Summary	Chi-Sq Statistic	Chi-Sq d.f	Prob.
Cross-section random	98.094644	5	0.0000

Source: Data processed by Eview 13, 2025

The Hausman test presented in Table 3 indicates that the probability result for the Cross-Section random model is lower than the significance level of 0.05, suggesting that the Fixed-Effect Model is the most appropriate. Since the results of both the Chow test and the Hausman test consistently indicate the Fixed-Effect Model, further testing using the Lagrange Multiplier (LM) test is not necessary.

Descriptive Statistical Analysis

Table 4 presents the descriptive statistics of the variables used in this study, including accounting conservatism (Y_AC), financial distress (X1_FD), leverage (X2_LV), and profitability (Z_P). The statistics summarise the distribution of data through mean, median, maximum, minimum, standard deviation, and number of observations. These measures provide an overview of the data characteristics, variability, and range, which are essential for understanding the behaviour of each variable before conducting further regression analysis.

Table 4 Statistics Descriptive

	Mean	Median	Max	Min	Std. Dev.	Obs
Y_AC	-0.0446	-0.0176	0.2471	-2.0404	0.2418	80
X1_FD	3.9723	3.2779	11.5314	0.4360	2.0438	80
X2_LV	1.0475	0.5758	17.0373	0.1085	2.4061	80
Z_P	136.4743	11.4122	8960.8200	-310.3664	1004.5770	80

Source: Data processed by Eview 13, 2025

Based on Table 4, the assessment of descriptive statistics can be explained. Accounting conservatism (Y), as the dependent variable in this study, is measured using the ratio that captures the difference between operating income and cash flows from operations relative to total assets. The negative mean value (-0.0446) indicates that most firms tend to report earnings more aggressively. The lowest extreme value was recorded by PSDN in 2023, suggesting potential issues in financial reporting or a weak capital structure.

Financial distress (X1), as measured by the Altman Z-Score model, has an average of 3.9723. This result implies that most firms are in a financially healthy condition. The highest Z-Score (11.5314) was observed in CEKA in 2022, indicating strong financial capacity and a position far from bankruptcy risk.

Leverage (X2), calculated from the debt-to-equity ratio, has an average value of 1.0475. This reflects a generally moderate use of debt, although an outlier was found in PSDN in 2022 with an exceptionally high ratio (17.0373), indicating excessive reliance on external financing. Profitability (Z), measured by ROA, demonstrates a very wide distribution. The mean ROA of 136.47 does not accurately represent the overall condition due to the presence of extreme outliers, such as an exceptionally high ROA at HOKI in 2022 (8960.82) and a sharp negative in the following year (-310.37). These finding highlights significant volatility in the financial performance of the sampled firms.

Multiple Regression Analysis

Table 7 Multiple Linear Regression Analysis Results

Variable	Coefficient	t-Stat	Probability
C	-0.0596	-0.8758	0.1925
FD	-0.0151	-1.5494	0.0635
LV	0.0651	1.639	0.0535
P	0.0004	0.3242	0.3735
FD*P	-0.0001	-0.337	0.3687
LV*P	-0.0001	-0.0807	0.468
R^2	0.5372		
Adj R^2	0.3352		
F-stat	2.6596		
Prob(F-stat)	0.0014		

Source: Data processed by Eview 13, 2025

The multiple linear regression equation derived in this study is formulated as follows:

$$AC = a + \beta_1 FD + \beta_2 LEV + \beta_3 PROF + \beta_4 (FD.PROF) + \beta_5 (LEV.PROF) + e$$

Table 7. can be interpreted into the multiple regression equation as follows:

$$AC = -0.0596 - 0.0151 + 0.0651 + 0.0004 - 0.0001 - 0.0001 + e$$

The results of the analysis on the regression model equation imply that the relationship between the independent variable (X) and the dependent variable (Y)-accounting conservatism is explained as follows:

1. The constant value of -0.0596 suggests that, when financial distress (X1), leverage (X2), and profitability (Z) are absent, accounting conservatism tends to exhibit a negative value, or when these three variables are equal to zero.
2. The financial distress (X1) coefficient is -0.0151. The negative sign of the coefficient indicates that financial distress has a negative influence on accounting conservatism. Specifically, a 1% increase in financial distress leads to a 0.0151 decrease in accounting conservatism. This finding implies that the greater the level of financial distress experienced by a company, the lower its tendency to apply accounting conservatism.
3. The leverage (X2) coefficient is 0.0651. The positive value of the coefficient indicates that leverage has a positive impact on the application of accounting conservatism. Specifically, a 1% increase in leverage results in a 0.0651 increase in accounting conservatism. This suggests that the higher the leverage (level of debt), the greater the extent to which accounting conservatism is applied.
4. The profitability (Z) coefficient is 0.0004. The positive sign of the coefficient indicates that profitability has a positive influence on accounting conservatism. Specifically, a 1% increase in profitability leads to a 0.0004 increase in accounting conservatism. This suggests that higher profitability slightly enhances the level of accounting conservatism. However, given the small magnitude of the coefficient, its effect is likely to be insignificant.
5. The coefficient of the interaction between financial distress and profitability is -0.0001. This interaction suggests that the effect of financial distress on accounting conservatism decreases as profitability increases, meaning that profitability mitigates the negative influence of financial distress on accounting conservatism. However, given the small magnitude of the coefficient, the effect is likely to be insignificant.
6. The coefficient of the interaction between leverage and profitability is -0.0001. This interaction suggests that the effect of leverage on accounting conservatism diminishes as profitability increases, or in other words, profitability weakens the influence of leverage on accounting conservatism. However, given the small magnitude of the coefficient, the effect is likely to be insignificant.

Coefficient of Determination

The coefficient of determination (R^2) was employed to evaluate the explanatory power of the regression model in describing the variation of the dependent variable. As presented in Table 8, the R^2 value of 0.5372 indicates that approximately 53.7% of the variation in accounting conservatism can be explained by financial distress, leverage, profitability, and their interaction terms. Meanwhile, the adjusted R^2 of 0.3352 reflects the model's goodness of fit after adjusting for the number of predictors. These results suggest that the model has a moderate explanatory power and is statistically valid for further interpretation. The coefficient of determination (R^2) value of 0.5372 indicates that more than half of the variation in accounting conservatism is explained by the independent variables in the model, specifically financial distress, leverage, profitability, and their interaction terms. This indicates that the predictors have substantial explanatory power in the context of this research. However, the adjusted R^2 of 0.3352, which accounts for the number of variables included, shows a decrease compared to the unadjusted R^2. This gap implies that while the model can explain a considerable portion of the variation, there are other external factors beyond the tested variables that may also contribute to accounting conservatism but are not captured in the model. Despite this limitation, the significant F-statistic probability (0.0014) strengthens the

evidence that the model as a whole is statistically meaningful, confirming its adequacy for hypothesis testing and further interpretation.

Table 8 Coefficient Determination Testing

Variable	Coefficient	t-Stat	Probability
C	-0.0596	-0.8758	0.1925
FD	-0.0151	-1.5494	0.0635
LV	0.0651	1.639	0.0535
P	0.0004	0.3242	0.3735
FD*P	-0.0001	-0.337	0.3687
LV*P	-0.0001	-0.0807	0.468
R^2	0.5372		
Adjusted R^2	0.3352		
F-statistic	2.6596		
Prob(F-stat)	0.0014		

Source: Data processed by Eview 13, 2025

F Test

The F-test was conducted to examine the overall significance of the regression model by assessing whether the independent variables jointly explain variations in the dependent variable. As shown in Table 9, the model yields an F-statistic value of 2.6596 with a probability value of 0.0014. Since the probability is lower than the significance level of 0.05, the null hypothesis that all coefficients are simultaneously equal to zero is rejected. This indicates that financial distress, leverage, profitability, and their interaction terms collectively have a significant effect on accounting conservatism within the observed sample.

Table 9. F Test

Variable	Coefficient	Std. Error	t-Stat	Probability
C	-0.0596	0.068	-0.8758	0.1925
FD	-0.0151	0.0098	-1.5494	0.0635
LV	0.0651	0.0397	1.639	0.0535
P	0.0004	0.0011	0.3242	0.3735
FD*P	-0.0001	0.0003	-0.337	0.3687
LV*P	-0.0001	0.0018	-0.0807	0.468
R-squared (R^2)	0.5372			
Adjusted R^2	0.3352			
F-stat	2.6596			
Prob(F-stat)	0.0014			

Source: Data processed by Eview 13, 2025

T Test

The t-test was conducted to examine the partial effect of each independent variable on accounting conservatism within the regression model. As presented in Table 10, the coefficients, t-statistics, and probability values indicate the direction and significance of each relationship. This test is crucial for identifying which predictors—financial distress (FD), leverage (LV), profitability (P), and their interaction terms—individually contribute to explaining variations in the dependent variable. By comparing the probability values with the 5% significance level, the analysis provides evidence on whether each hypothesis is supported, thereby offering more profound insights into the determinants of accounting conservatism.

Table 10. T Test

Variable	Coefficient	Std. Error	t-Stat	Probability
C	-0.0596	0.068	-0.8758	0.1925
FD	-0.0151	0.0098	-1.5494	0.0635
LV	0.0651	0.0397	1.639	0.0535
P	0.0004	0.0011	0.3242	0.3735
FD*P	-0.0001	0.0003	-0.337	0.3687
LV*P	-0.0001	0.0018	-0.0807	0.468
R-squared (R^2)	0.5372			
Adjusted R^2	0.3352			
F-statistic	2.6596			
Prob(F-stat)	0.0014			

Source: Data processed by Eview 13, 2025

This study elaborates on the analysis presented in Table 10 as follows:

1. The financial distress variable (X1) has a negative coefficient of -0.0151 with a probability value of 0.0635. Since $p < 0.10$ and the t-statistic of 1.5494 is greater than the t-table value of 1.289, X1 is partially found to have a negative and significant effect on the dependent variable at the 10% significance level. This indicates that an increase in X1 tends to reduce the value of the dependent variable.
2. The leverage variable (X2) shows a positive coefficient of 0.0651 with a probability value of 0.0535. Because $p < 0.10$ and the t-statistic of 1.6390 exceeds the t-table value of 1.289, X2 is concluded to have a positive and significant effect on the dependent variable at the 10% significance level. This suggests that an increase in leverage leads to a higher value of the dependent variable.
3. The profitability variable (Z) has a coefficient of 0.0004, a p-value of 0.3735, and a t-statistic of 0.3242, which is lower than the t-table value of 1.289. This result indicates that profitability is not significant and therefore does not influence the dependent variable.
4. The interaction between financial distress (X1) and profitability (Z) yields a coefficient of -0.0001 with a probability value of 0.3687 and a t-statistic of 0.3370, which is below the t-table value of 1.289. This finding demonstrates that the interaction between financial distress and profitability is not significant, implying that profitability does not weaken or alter the effect of financial distress on the dependent variable.
5. The interaction between leverage (X2) and profitability (Z) has a coefficient of -0.0001, a probability value of 0.4680, and a t-statistic of 0.0807, which is also lower than the t-table value of 1.289. This result indicates that the interaction between leverage and profitability is not significant, meaning that profitability does not strengthen or alter the effect of leverage on the dependent variable.

4. Discussion

Financial Distress Negatively Affects Accounting Conservatism

The findings of this study demonstrate that financial distress exerts a significant negative influence on accounting conservatism, implying that firms experiencing financial difficulties tend to reduce their application of prudent reporting practices. This result is consistent with previous empirical evidence highlighting the role of financial pressure in shaping managerial reporting behaviour. For instance, Papadaki and Pavlopoulou-Lelaki (2022) emphasised that financial distress compromises the quality of financial reporting, as firms often attempt to present a more favourable performance to maintain investor and creditor confidence. In line with this, Sun et al. (2023) revealed that firms facing severe financial distress are less likely to maintain conservative accounting policies, as the priority shifts from prudent disclosure to short-term survival strategies. These findings support the notion that distress conditions diminish the incentives to exercise caution in financial reporting, thereby confirming the study's outcome. The evidence also aligns with the broader literature on

accounting conservatism as a protective mechanism for creditors and stakeholders. Accounting conservatism reduces bankruptcy risk by providing timely recognition of losses, thereby protecting creditor recovery prospects. However, when firms are in distress, such protective mechanisms may be intentionally weakened, as management seeks to mask potential losses or financial instability. This paradox illustrates that, although conservatism serves to mitigate risk under normal conditions, financial distress fundamentally alters managerial incentives and reporting strategies.

Moreover, Pujiono, Radityo, Kusumaningtias, and Putra (2023) observed that the interaction between leverage, financial distress, and conservatism is complex. Their findings indicated that while leverage generally increases the need for conservatism, financial distress can offset this effect by encouraging less prudent reporting. These results align with the interpretation of the present study, which found that distress leads to reduced conservatism, contrary to theoretical expectations of heightened prudence under debt pressures. Similarly, Phuong Hong and Tra My (2024) highlighted that firm-specific financial characteristics, including distress, significantly determine the degree of conservatism, underscoring the role of financial health in influencing reporting choices. Taken together, the consistency between this study and prior research strengthens the argument that financial distress undermines the practice of accounting conservatism. Thus, first hypothesis is accepted.

Leverage Positively Affects Accounting Conservatism

The findings of this study indicate that leverage exerts a positive and significant effect on accounting conservatism at the 10% significance level. This suggests that firms with higher debt ratios are more likely to adopt conservative reporting practices in order to safeguard creditor interests and mitigate the risk of overstatement. The result supports the view that leverage acts as a disciplining mechanism, compelling management to implement more cautious accounting policies in response to increased monitoring by creditors. This outcome is consistent with prior research emphasising the contractual role of conservatism in reducing agency conflicts between debtholders and shareholders.

Atwa, Bsoul, Kharabsheh, and Azzam (2022) reported similar findings, demonstrating that firms with higher leverage are inclined to adopt more conservative accounting practices to reduce information asymmetry and assure creditors of the reliability of reported earnings. Their results highlight how leverage strengthens managerial incentives to apply prudence in financial reporting. Likewise, Ramalingegowda and Yu (2021) found that leverage influences capital structure adjustments and motivates the use of conservatism as a mechanism to align creditor protection with managerial reporting incentives. Both studies provide direct support for the positive association observed in the present analysis.

In addition, financial characteristics such as leverage significantly influence the degree of conservatism adopted by firms in emerging markets. Their findings suggest that when firms face higher debt obligations, conservatism becomes a strategic choice to preserve credibility in the eyes of both creditors and investors. Al-Fasfus, Al-Rawashdeh, Al-Theebeh, and Al-Enabi (2022) also emphasised the role of conservatism in strengthening financial performance and accountability, which becomes particularly crucial when firms rely heavily on external financing. Taken together, these studies demonstrate strong consistency with the present results. High leverage not only increases the demand for conservatism but also provides firms with a contractual incentive to maintain credibility and reduce risks associated with excessive optimism in financial reporting. Thus, the second hypothesis is accepted.

Profitability (Z) Weakens the Negative Influence of Financial Distress (X1) on Accounting Conservatism (Y)

The finding that profitability does not significantly moderate the relationship between financial distress and accounting conservatism ($p = 0.3687$) is consistent with evidence that distress pressures can dominate firms' reporting choices, even when performance is strong. Research shows that conservatism reduces bankruptcy risk by accelerating loss recognition; however, under distress, managerial incentives shift toward portraying short-term resilience, thereby weakening prudence (Sun et al., 2023). In such settings, profitability may fail to buffer the reporting effects of distress because the strategic imperative to sustain access to financing outweighs the disciplining role of recent earnings.

Contextual factors help explain this non-result. First, conservatism is shaped by capital structure dynamics and creditor governance rather than profitability alone. When leverage and covenant pressures are salient, lenders' demand for verifiable signals can supersede the informational content of profitability, rendering the FD-conservatism link relatively insensitive to ROA levels. Second, prior work documents that measurement properties of accounting numbers and disclosure environments can attenuate statistical detection of interaction effects. Large dispersion in profitability, earnings transients, and non-recurring items reduces the reliability of performance as a conditioning signal, while institutional features and reporting frictions can dilute the mapping from profitability to conservative recognition (Brennan & Merkl-Davies, 2018; Zadeh et al., 2022). These mechanisms mirror the concerns of the present study regarding extreme variability and potential range restriction in ROA. Third, profitability may operate through alternative channels—such as relaxing financing frictions or facilitating capital structure adjustments—rather than altering the sensitivity of conservatism to distress per se (Kim et al., 2023; Ramalingegowda & Yu, 2021). Evidence that firm characteristics jointly determine conservatism (Phuong Hong & Tra My, 2024) and that sectoral or regulatory contexts shape prudence (Acharya & Ryan, 2016; Ha, 2021) further suggests that moderation by profitability is conditional and potentially nonlinear. Relatedly, when leverage and distress covary, multicollinearity and weak simple correlations among constituent terms can reduce the power to detect interaction effects even when main effects remain significant (Caskey & Laux, 2017).

Profitability (Z) strengthens the positive effect of leverage (X2) on accounting conservatism (Y).

The regression result for the interaction between leverage and profitability (LEV × PROF) indicates an insignificant effect (p = 0.4680), implying that profitability does not moderate the relationship between debt structure and accounting conservatism. Conceptually, higher leverage is often expected to encourage more conservative reporting to reassure creditors, and firm profitability could, in Theory, reinforce this tendency. The empirical evidence here, however, does not support that expectation. This non-result is consistent with strands of prior research showing that capital structure and contracting pressures are primary, whereas profitability operates only indirectly or through alternative channels. Leverage elevates creditors' demand for timely loss recognition and verifiable signals, strengthening the baseline role of conservatism as a contracting device (Atwa et al., 2022; Ramalingegowda & Yu, 2021). Conservatism also functions to curb downside risk and potential failure (Biddle et al., 2022). However, these effects need not become stronger simply because profitability is high; lender monitoring and covenant considerations may dominate the reporting choice regardless of contemporaneous earnings. In this sense, the present finding aligns with evidence that conservatism is closely tied to leverage and financing frictions, rather than to the interaction of leverage with profitability.

Moreover, although the role of profitability in disclosure credibility and stakeholder assurance has been documented, it does not always translate into a more substantial marginal effect on conservative recognition in leveraged settings. Studies have noted performance–reporting links and the constraint-reducing properties of conservatism, but these influences can be mitigated by broader governance, communication, and informational environments (Brennan & Merkl-Davies, 2018; Zadeh et al., 2022). Practical measurement issues may further attenuate moderation tests, as noisy profitability, transitory earnings, and heterogeneity in reporting practices can weaken the statistical power to detect interaction effects. In line with this idea, firm characteristics have been shown to shape conservatism in complex, sometimes non-linear ways; therefore, moderation by profitability may be context-dependent and not universal. These findings confirm that not all moderation variables function effectively in every causal relationship. The findings also suggest that profitability may reinforce the influence of leverage on conservatism as companies look to maintain reporting stability and attract investors' attention.

5. Conclusion

This study examines the impact of financial distress and leverage on accounting conservatism, and whether profitability moderates these relationships in an increasingly volatile economic environment. Using a panel of food-and-beverage manufacturers listed on the IDX (2020–2023), we estimate a fixed-effects model to isolate firm-specific heterogeneity and test four hypotheses linking

distress, leverage, and profitability to accrual-based conservatism (CONACC). The main findings are threefold. First, financial distress exerts a negative and statistically significant influence on accounting conservatism, indicating that firms under pressure tend to relax prudence in recognition to sustain an appearance of performance. Second, leverage has a positive and significant effect on conservatism, consistent with creditor monitoring and contracting demands that encourage timely recognition of losses. Third, profitability does not significantly moderate either the distress–conservatism or the leverage–conservatism relationships, suggesting that performance strength neither buffers the dampening effect of distress nor amplifies the disciplining role of leverage.

The study has limitations. The sectoral focus and sample size (20 firms) constrain generalizability. Measurement noise and extreme dispersion in ROA may reduce the power to detect interaction effects. The use of a single conservatism proxy (CONACC) may not capture conditional versus unconditional dimensions. Unobserved institutional and governance factors were not directly modelled. Despite these constraints, the research makes a significant contribution by jointly examining distress, leverage, and profitability within a single framework, thereby clarifying the mixed evidence on the drivers of conservatism in emerging-market settings. Practically, the results imply that creditors and regulators should not rely on profitability signals to safeguard prudence during stress; strengthening covenant design, disclosure oversight, and governance may be more effective. For managers, the evidence underscores that conservative reporting credibly supports access to debt markets, while aggressive recognition under distress risks erodes stakeholder trust. Future work should incorporate multi-proxy conservatism measures, governance variables, and broader cross-sector samples.

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