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Effect of Accounting Conservatism on Investment Efficiency with Litigation Risk as Moderating Variable

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Abstract

This study aims to examine and analyze the effect of accounting conservatism on investment efficiency with litigation risk as a moderating variable. The research was conducted at all manufacturing companies listed on the Indonesia Stock Exchange during the 2015-2019 period. The method of determining the sample in this study uses a non-probability sampling method with a purposive sampling technique. The number of samples in this study was 490 company financial reports. The analysis technique used in this research is simple linear regression and Moderated Regression Analysis (MRA). The results show that the level of investment in manufacturing sector companies will be more efficient when the company applies accounting conservatism. The role of accounting conservatism in increasing investment efficiency will be stronger when companies apply litigation risk.

Introduction

Investment plays an important role in driving economic growth and employment in Indonesia. The manufacturing industry sector is the main sector with the largest contribution to Indonesia's economic growth. Based on data from the Central Bureau of Statistics, the decline in the contribution of the manufacturing sector in the last five years is a result of a decrease in imports of raw materials and capital goods, which indicates that the competitiveness of the business climate and the investment climate in the national manufacturing or processing sector is declining (www.republika.co.id, January 2020). The production capacity contained in the manufacturing industry sector can be increased in various ways, one of which is by investing, especially in real

assets such as purchasing productive assets, establishing factories, opening mining, opening plantations, and others (Gao & Yu, 2020). Investment is said to be efficient if it is avoided from overinvestment or underinvestment conditions (Sari & Suaryana, 2014). Companies with high levels of leverage will tend to experience underinvestment conditions. Prasetio's research (Prasetio & Suryono, 2016) states that the existence of excess capital (free cash flow) in companies with slow growth rates is the cause of the problem of overinvestment.

The company's investment efficiency is measured by a research model by Biddle (Biddle et al., 2009) which estimates the level of investment that the company expects in the year of observation based on the opportunity for the rate of sales growth. Sales growth reflects the successful manifestation of investment in the past period which can be used as a prediction for future sales growth. Empirical data regarding sales growth and total assets in manufacturing companies listed on the Indonesia Stock Exchange with operating profits during 2015-2019 can be presented in the following Table 1.

Table 1. Growth Rate of Total Assets, Sales and Business Profit Growth of Manufacturing Companies in 2015 - 2019

CODE	Indicator	2015	2016	2017	2018	2019
INTP	Sales	17,798,055	15,361,894	14,431,211	15,190,283	15,939,348
	Growth	-11%	-14%	-6%	5%	5%
	Fixed assets	14,212,157	15,097,594	15,435,700	15,285,784	14,787,158
	Growth	13%	6%	2%	-1%	-3%
	Operating profit	5,056,930	3,644,595	1,874,845	1,074,111	1,905,055
	Growth	-15%	-28%	-49%	-43%	77%
KRAS	Sales	19,373,960	18,067,591	19,631,323	25,190,206	19,745,660
	Growth	-17%	-7%	9%	28%	-22%
	Fixed assets	36,232,280	33,628,937	36,891,718	41,287,836	36,087,296
	Growth	145%	-7%	10%	12%	-13%
	Operating profit	(2,532,058)	58,984	687,479	(1,348,326)	(6,238,254)
	Growth	187%	-102%	1066%	-296%	363%

(In million IDR)

Data source: IDX 2015 - 2019. Processed data

Table 1 shows if a company coded INTP has obtained a growth in total fixed assets since 2015 of 13%, but there has been a decline in sales until 2017 and experienced a negative operating profit until 2018 of 43%. The company coded KRAS received a growth in total fixed assets in 2018 of 12%, but experienced a decrease in sales in 2019 by 22%, and received a negative operating profit in the last two years, namely 2018 and 2019. This phenomenon shows that the increase in the growth of total fixed assets or the investment opportunities

taken is not balanced with the increase in sales growth and operating profits expected by shareholders.

For creditors and investors, earnings information helps in evaluating the company's performance, predicting future profits, and calculating the risk of investing or lending to companies (Aditya & Naomi, 2017). Investors avoid companies that have a high-profit volatility level because they have a large risk, so investors tend to like companies with a low-profit volatility level (Lee & Mo, 2020). Managers in presenting quality information are faced with limitations commonly called constraints, namely, cost-benefit relationship, materiality principle, industry practice, and conservatism. Accounting conservatism is an attitude of caution (prudent reaction) in dealing with the uncertainty and risks inherent in the business environment. Accounting conservatism is also a valuation principle that affects accounting practice and is an important convention in financial reporting (Basu, 1997).

Accounting conservatism is an approach taken when there are doubts in choosing a way that supports the reflection of assets and income that are higher than the actual value (Kieso et al., 2014). Lara's research (Lara et al., 2016) explains that accounting conservatism helps managers in making efficient investment decisions through three things. The first reduce agency problems by limiting the opportunistic behavior of managers and facilitating monitoring of managerial investment decisions. Second, by increasing managerial incentives to reduce underperforming investment projects earlier. Third, facilitate access to external finance at lower costs. Agency theory explains one way to reduce agency problems by applying the principle of prudence in presenting financial reports, meaning that managers have realized that opportunistic behavior can increase information asymmetry with stakeholders which can lead companies into inefficient investment projects because managers are not transparent about conditions. companies to stakeholders (Yunita & Suprasto, 2018). Information in financial reports is strongly influenced by management behavior in preparing financial statement figures (Roychowdhury et al., 2019).

Conservatism is an attitude or flow in the face of uncertainty to take actions or decisions based on the emergence of the worst outcome of this uncertainty (Suwardjono, 2016). Conservatism also causes an understatement of earnings in the current period which can lead to an overstatement of earnings in subsequent periods, as a result of an understatement of costs in that period (Watts, 2003). Fala's research (Fala, 2006) emphasizes that the understatement of systematic or relatively permanent net assets is a hallmark of accounting conservatism. So it can be said that accounting conservatism generates quality profits because this principle prevents companies from exaggerating profits and helps financial users by presenting profits and assets that are not overstated, so that company investment can avoid over/underinvestment. (Aminu & Hassan, 2016), (Lara et al., 2016), (Razzaq et al., 2016) in their research found evidence that conservatism is positively related to investment efficiency. Based on this, the first hypothesis in this study is as follows.

H1: Accounting conservatism has a positive effect on investment efficiency.

The adoption of conservatism from accountants is important to offset excessive optimism between managers and owners because under-valuing is harmful than understating profits (the consequences of bankruptcy are more serious than profits), to reduce risks (tax risk, government oversight, investment analysts, and dividend payout risk, which is high for investors) (Pratiwi, 2017). The overstated presentation of net assets is one of the causes of high litigation costs. Companies report low net assets as an effort to minimize litigation costs that can arise due to third parties (Ratnadi&Ulupui, 2016). One of the risks that have a significant impact on the company's investment activities is the risk that is caused by non-compliance with existing provisions, such as provisions in the presentation of financial statements, provisions for product supply, financing provisions, tax provisions, and other provisions in contractual agreements, which results in losses of third parties (creditors, investors, regulators), which can lead the company into the realm of law/litigation (Putri et al., 2017). The risk of litigation is defined as several risk indicators that determine the likelihood of litigation. The indicators used are stock returns, liquidity, leverage, operational efficiency, and company size (Juanda, 2010). Generally, companies avoid legal action because they can give a bad image that will influence investors' interest in investing.

Litigation risk is a factor that encourages managers to present financial reports more conservatively. The incentive for managers to apply accounting conservatism will be even stronger if the risk of litigation in the company is relatively high. In line with Chung's research (Chung et al., 2013), stating that low litigation risk will make managers' attitudes not to be careful in presenting financial reports which can hinder the efficiency of the company's capital allocation. The effect of accounting conservatism will be low on investment efficiency with companies that have low litigation risk. Conversely, the effect of accounting conservatism will be strong when the litigation risk faced by the company is high. Based on these theoretical and empirical studies, the second hypothesis in this study is as follows.

H2: Litigation risk strengthens the effect of accounting conservatism on investment efficiency.

Based on the framework of thinking, a research concept can be developed that shows a logical relationship between research variables. The concept of this research is presented in Figure 1.

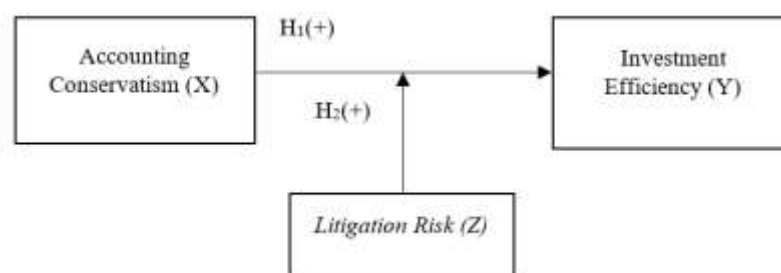


Figure 1. Research Concept

Research Methods

The data used in this study is secondary data obtained through annual reports of companies listed on the Indonesia Stock Exchange. The object of this research is the investment efficiency of manufacturing companies on the Indonesia Stock Exchange which is explained by accounting conservatism and litigation risk. In this study, the non-participant observation method is in the form of analysis of company records, which is to collect annual financial report data and financial ratios obtained through the Indonesia Stock Exchange on the website www.idx.co.id. The population of this study is the manufacturing sector companies listed on the Indonesia Stock Exchange during the 2015-2019 period, to obtain a total population of 98 companies. The selection of the research sample was based on the non-probability sampling method with purposive sampling technique, which is a sampling technique with certain considerations or criteria (Sugiyono, 2017), obtained a total sample of 490 company financial reports.

The investment efficiency variable in research is measured by the research model by Biddle (Biddle et al., 2009). The reason for this model is used to estimate the level of investment expected by company *i* in year *t* based on growth opportunities, which is measured by sales growth. The accounting conservatism variable is measured by the Givoly accrual model (Givoly&Hayn, 2002). Profit and cash flow is an advantage of capital investment and is important information for investors to know its progress. Measuring litigation risk uses research conducted by Juanda (Juanda, 2010) which refers to Qiang (Qiang, 2003), which measures litigation risk from the ex-ante side, namely indicators that can lead to litigation. Measurement of litigation risk uses component factor analysis of several indicators such as stock returns, stock turnover, liquidity, solvency, operational efficiency, and company size. If all indicators are construct indicators, they will automatically be grouped with a high loading factor or greater than 0.5 (Ghozali, 2016). The data analysis technique used in this research is simple linear regression analysis and Moderated Regression Analysis (MRA). The regression model is as follows.

$$Y = \alpha + \beta_1 X + \beta_2 Z + \beta_3 X * Z + \varepsilon \quad (1)$$

Results and Discussion

Based on the results of the descriptive statistical test in table 4, shows the number of *N* as much as 490, which indicates that there are 490 observational data examined in this study. Investment efficiency has an average value of 0.3122, with a standard deviation of 0.891. This means that there is a difference in the value of investment efficiency understudy against the average value of 0.891 percent. Accounting conservatism has an average value of 0.155, with a standard deviation of 1.776. This means that there is a difference in the value of accounting conservatism understudy against the average value of 1.776 percent. Litigation risk has an average value of 0.3437, with a standard deviation of 0.3849. This means that there is a difference in the value of Litigation risk understudy against the average value of 0.3849 percent.

Table 2. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ABS_INVEST	490	.00341	12.08057	.3122582	.89110700
CONACC	490	-14.288785	12.293690	.15541468	1.776490898
LITRISK	490	.020853	5.428757	.34378035	.384995965
Valid (listwise)	N490				

Data source: Data processed, 2020

Based on Table 2, it can be seen that the Kolmogorov Test Statistic value is 1.285, while the Asymp value. Sig. (2-tailed) of 0.074. These results indicate that the regression equation model is normally distributed because of the Asymp value. Sig. (2-tailed) 0.074 is greater than the alpha value of 0.05.

Table 3. Normality Test Results (One-Sample Kolmogorov-Smirnov Test)

		Unstandardized Residual
N		490
Normal Parameters ^{a,b}	Mean	-.0928357
	Std. Deviation	1.02033780
Most Extreme Differences	Absolute	.058
	Positive	.058
	Negative	-.058
Kolmogorov-Smirnov Z		1.285
Asymp. Sig. (2-tailed)		.074

Data source: Data processed, 2020

Based on Table 3, it can be seen that the Kolmogorov Smirnov Test Statistic (K-S) value is 1.285, while the Asymp value. Sig. (2-tailed) of 0.074. These results indicate that the regression equation model is normally distributed because of the Asymp value. Sig. (2-tailed) 0.074 is greater than the alpha value of 0.05.

Table 4. Autocorrelation Test Results

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.514 ^a	.264	.260	.76663037	1.900

Data source: Data processed, 2020

Based on Table 4, it shows the DW value of 1,900, this value when compared with the significance table value of 5%, the number of samples is 490 (n), and the number of variables that affect the dependent variable (K = 3), then the du

value is 1.85987. The DW value of 1,900 is more than the upper limit (du), namely 1, 85987 and less than (4-du) 4-1, 85987 = 2.14013, so it can be concluded that the data has passed the autocorrelation test using the Durbin Watson test.

Table 5. Heteroscedasticity Test Results Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	.796	.042		18.770	.000
CONACC	.019	.018	.048	1.052	.294
LITRISK	-.142	.082	-.078	-1.721	.086
Interaction CONACC and LITRISK	.002	.004	.021	.455	.649

Data source: Data processed, 2020

Based on Table 5, the results of the heteroscedasticity test show that accounting conservatism has a significance value of 0.294, then litigation risk has a significance value of 0.086, and the interaction of the accounting conservatism variable with litigation risk has a significance value of 0.649. This value indicates that all variables have a value greater than 0.05, which means that there is no influence between the independent variables on absolute residuals. Thus, the model made does not contain symptoms of heteroscedasticity.

Table 6. Model Feasibility Test Results (F-Test) ANOVA^a

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	102.462	3	34.154	58.112	.000 ^a
Residual	285.045	485	.588		
Total	387.507	488			

Data source: Data processed, 2020

The results of the F-test show that the calculated F value is 58.112 with a significance P-value of 0.000 which is smaller than $\alpha = 0.05$, this means that the model used in this study is feasible. This result means that all variables of accounting conservatism (X), litigation risk (Z), and the interaction variable between accounting conservatism and litigation risk (XZ) can predict or explain the phenomenon of investment efficiency in manufacturing companies listed on the Indonesia Stock Exchange for the 2015-2019 period.

Table 7. Results of Simple Linear Regression Analysis

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	
	B	Std. Error	Beta			
1	(Constant)	.276	.036		7.697	.000
	CONACC	.233	.020	.464	11.558	.000

a. Dependent Variable: Investment Efficiency

Data source: Data processed, 2020

Based on the results in Table 7, the following regression equation can be made.

$$Y = 0,276 + 0,233 X \quad (2)$$

The significance value of the accounting conservatism variable is 0,000 or less than 0.05. This shows that the accounting conservatism variable has a significant effect on the investment efficiency variable. Based on the results of the analysis of the effect of accounting conservatism on investment efficiency, it is obtained a significance value of 0.000 with a t value of 11.558 and a regression coefficient of 0.233 which is positive. The significance value of $0.000 < 0.05$ indicates that H_0 is rejected and H_1 is accepted. This result means that accounting conservatism has a positive and significant effect on investment efficiency. This means that the higher the application of accounting conservatism, the higher the level of company investment efficiency. The increase in accounting conservatism is due to the increased awareness of company management to present net assets which lead to systematic or relatively permanent understate, as a result of future economic uncertainty. The goal is to generate profits and free cash flow that is not overstated so that the company's investment activities become more efficient because they have sufficient free cash flow (Lara et al., 2016). Conservatism leads to a better selection of investment projects and facilitating projects that generate lower returns. Conservatism has an important role in the company's financial statements as the basis for making investment decisions (Juliani & Wardhani, 2018).

The results of the study support agency theory which explains one way of reducing agency problems between shareholders and management regarding information asymmetry. Management who is entrusted with managing the company is obliged to apply accounting conservatism and provide information to shareholders regarding investment opportunities that will benefit the company. In line with Handayani's research (Handayani et al., 2016), monitoring by shareholders can reduce information asymmetry. Reduced information asymmetry indicates quality information disclosure and will increase investment efficiency. Based on the measurement used in this study, the researcher uses conditional conservatism because this type of conservatism describes contracting efficiency by minimizing the manager's incentive to take investment projects that ex-ante have a negative or inefficient NPV.

Conditional conservatism can also be used more as an indicator of the presence of quality financial statements because, with the application of this conditional conservatism, the company's financial statements can describe the actual condition of the company, where the reduction in accounting profit is a reflection of the ongoing economic loss.

Table 8. Moderated Regression Analysis Test Results

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	.129	.047		2.764	.006
CONACC	.237	.020	.473	12.134	.000
LITRISK	.418	.091	.181	4.613	.000
Interaction CONACC and LITRISK	.013	.004	.113	2.876	.004

a. Dependent Variable: Efficiency of investment

Data source: Data processed, 2020

In Table 8, the structural equation is as follows.

$$Y = 0,129 + 0,237X + 0,418 Z + 0,013 X Z \quad (3)$$

Based on the results of the analysis of the effect of accounting conservatism on investment efficiency with litigation risk as a moderating variable, it is obtained a significance value of 0.000 with a positive t value of 12.134. The significance value of the moderating variable (β_2) litigation risk is 0,000 (significant) and the significant value of the interaction variable between accounting conservatism and litigation risk (β_3) is significant at 0.004, this indicates that the moderating variable is a quasi-moderation type. Moderated regression analysis shows that the value of the accounting conservatism variable is significant and the interaction variable between accounting conservatism and litigation risk is also significant, so it shows a unidirectional relationship, so it is concluded that the variable litigation risk is a moderating variable that strengthens the effect of accounting conservatism on investment efficiency. This indicates that the higher the level of corporate litigation risk, the higher the effect of accounting conservatism on investment efficiency.

Based on Table 9, it shows that the MSA value of the stock return variable (RETt) is 0.431, the MSA value of the stock turnover variable (TURNOVt) is 0.447, the MSA value of the operational efficiency variable (EO) is 0.500, the MSA value of the liquidity variable (LIKt) is 0.496, the MSA value the leverage variable (LEVt) is 0.681, the MSA value for the firm size variable (Ln SIZEt) is 0.457. This means that only the Operational Efficiency (EO) and Leverage (LEVt) variables have an MSA value of ≥ 0.50 , so the model is suitable for use in factor analysis to determine the LITRISK index (Z). The

results of the factor analysis test prove that two indicators have an MSA value of > 0.50, namely the indicators of operational efficiency and leverage so that the model is suitable for use in factor analysis to determine the LITRISK index (Z). These two indicators can predict the emergence of litigation opportunities for the company.

Table 9.MSA Value for Litigation Risk Measurement (Anti-image Matrices)

		RET	TURNOV	EO	LIK	LEV	Ln Size
Anti-image Covariance	RET	.988	-.094	.029	-.006	.040	.018
	TURNOV	-.094	.883	-.264	.100	-.053	-.056
	EO	.029	-.264	.770	-.278	-.067	.134
	LIK	-.006	.100	-.278	.863	-.102	-.012
	LEV	.040	-.053	-.067	-.102	.963	-.015
	Ln Size	.018	-.056	.134	-.012	-.015	.974
Anti-image Correlation	RET	.431^a	-.101	.033	-.006	.041	.018
	TURNOV	-.101	.447^a	-.320	.114	-.058	-.060
	EO	.033	-.320	.500^a	-.341	-.078	.154
	LIK	-.006	.114	-.341	.496^a	-.112	-.013
	LEV	.041	-.058	-.078	-.112	.681^a	-.016
	Ln Size	.018	-.060	.154	-.013	-.016	.457^a

a. Measures of Sampling Adequacy (MSA)

Data source: Data processed, 2020

Litigation risk by creditors, investors, and regulators is a factor that encourages managers to present more conservative financial reports. The incentive for managers to apply accounting conservatism will be even stronger if the risk of litigation in the company is relatively high. This is in line with Chung's research (Chung et al., 2013), which states that low litigation risk will lead to management behavior not to be careful in presenting financial reports which can hinder the efficiency of the company's capital allocation. Litigation risk will affect the role of accounting conservatism on investment efficiency. The lower effect of accounting conservatism on investment efficiency with companies that have a low level of litigation risk. Conversely, the effect of accounting conservatism will be stronger when the level of litigation risk faced by the company tends to be high.

The results of the study support the contingency theory which states that the alignment of management strategies with the external business environment can determine the survival and performance of the company (McAdam et al., 2019). Litigation risk as an external factor that acts as a moderating variable is proven to be able to influence the interaction between the independent variable

and the dependent variable in this study. The litigation risk variable then plays a role in identifying and mitigating any existing risk through the application of accounting conservatism and its effect on investment efficiency will be even stronger.

Table 10. Test Results of the Coefficient of Determination (R^2)

Equation	<i>R Square</i>	<i>Adjusted R Square</i>
$Y = 0,276 + 0,233 X$	0,215	0,214
$Y = 0,129 + 0,237X + 0,418 Z + 0,013 X Z$	0,264	0,260

Data source: Data processed, 2020

The magnitude of the influence of the accounting conservatism variable on the investment efficiency variable is indicated by the adjusted R Square value of 0.214 which means that 21.4% of the variation in investment efficiency in manufacturing companies listed on the Indonesia Stock Exchange for the 2015-2019 period is influenced by variations in accounting conservatism (X), litigation risk (Z) and the interaction variable between accounting conservatism and litigation risk (X, Z), while the remaining 78.6% is explained by other factors that are not included in the model. The test results for moderated regression give a total determination value (adjusted R Square) of 0.260. This means that variations in investment efficiency in manufacturing companies listed on the Indonesia Stock Exchange 2015-2019 can be significantly influenced by accounting conservatism, litigation risk, and interaction variables between accounting conservatism and litigation risk by 26%, while the remaining 74% is explained by factors. other.

Conclusion

The results of the study prove that the level of investment in manufacturing sector companies will be more efficient when the company applies accounting conservatism. The role of accounting conservatism in increasing investment efficiency will be stronger when companies apply litigation risk. This can occur due to the increased awareness of company management to present non-overstate profit and free cash flow so that the company has sufficient funding sources to make the most efficient investment opportunities. Trustworthy management is obliged to apply accounting conservatism and provide information to shareholders regarding investment opportunities that will benefit the company. Litigation risk by creditors, investors, and regulators will encourage managers to present financial reports more conservatively. Further research can develop the use of risk indicators outside the financial statement figures such as risk indicators that are disclosed in the notes to the company's financial statements so that they can contribute significantly to risk management from the perspective of company management.

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