

PRUDENCE ACCOUNTING: THE ROLE OF FINANCIAL DISTRESS, FREE CASH FLOW, AND CAPITAL INTENSITY IN ACCOUNTING DECISIONS

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Abstract

This research analyzes the influence of financial distress, free cash flow, and capital intensity on prudent accounting. The research methods used are descriptive and verification methods. The population in this research is the 57 metal & mineral mining subsector companies listed on the Indonesia Stock Exchange in 2019-2022. The final sample was obtained from as many as 46 companies through the purposive sampling method, where the research was conducted for four years. The data collection technique used was non-participant. The analysis technique used is panel data regression analysis. The research results show that financial distress, free cash flow, and capital intensity influence accounting prudence. Economic distress, free cash flow, and capital intensity significantly positively affect prudence accounting.

Keywords: Financial Distress, Free Cash Flow, Capital Intensity, Prudence Accounting

INTRODUCTION

Financial statements are important information that reflects a company's performance and economic condition. This information is indispensable for creditors and investors when making decisions related to credit and investment. Although companies have confidence in determining accounting methods suitable for their respective situations, accounting reporting must be aligned with the requirements of Financial Accounting Standards (SAK) (Tazkiya, 2019). That way, company managers have the breadth in managing accounting to produce quality and relevant information but still have to comply with the principle of prudence or *prudence accounting*.

Prudence accounting is a prudent approach to recognizing assets or income and faster recognition of expenses or losses to avoid or reduce risks resulting from uncertainty in the business (Idrus et al., 2022). Principle *prudence accounting* has replaced accounting conservatism after IFRS was consolidated, where companies are required to remain cautious in recognizing income even though it is still a potential (Aristiani et al., 2017)

A real example of a lack of implementation of *prudence accounting* can be seen in the case of PT Timah Tbk (TINS), which revised its 2020 financial statements because it previously reported excessive profits (*overstated*). This revision shows a significant decrease in net profit, reduced from IDR 531.35 billion to IDR 132.29 billion, due to the lack of recording of revenue expenses and errors in the recognition and measurement of assets and income (Kompas.com, 2020).

This condition shows that applying low *prudence accounting* can negatively impact the company's performance and reduce *stakeholder* confidence. In this case, SAK in Indonesia, through PSAK Number 14 concerning Inventory and PSAK Number 48 relating to Asset Impairment, has set standards that require companies to apply *prudence accounting* in preparing financial statements.

Based on previous research, *prudence accounting* goods are characterized by a higher (positive) total accrual result, which indicates that the company applies the principle of more excellent Prudence. However, the low total value of accrual gives the idea that the application of *prudence accounting* is still limited (Aristiani et al., 2017).

The data collected from various companies on the Indonesia Stock Exchange (IDX) in the metal and mineral mining *subsector* category shows that most apply *Prudence, and the accounting value* is still small. This indicates that financial reporting has not adequately implemented the prudential principle. Therefore, it is essential to improve the implementation of *prudence accounting* to strengthen stakeholder trust and ensure that financial statements are accurate and reliable.

Along with the challenges these companies face, several factors, such as *financial distress*, amount of free cash, business size, and *leverage*, are suspected to influence the application of *prudence accounting*. This study intends to explore and evaluate the impact of these various factors on the application of *prudence accounting* in companies in *the metal and mineral mining* subsector in Indonesia.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Stewardship Theory

Stewardship Theory reveals the existence of cooperation between capital owners (primary) and capital managers (*stewards*) to achieve the same goal. This harmonization is reflected in the leadership pattern and communication between shareholders and management.

This theory is based on the assumption that humans can be trusted, responsible, and have integrity, where the CEO, as a steward, acts for the benefit of the organization, not personal goals (Published in 2009).

This theory underlines the importance of applying the principle of Prudence (*prudence accounting*) as a form of responsibility and integrity in presenting financial information. This principle helps minimize the risk of uncertainty by presenting more conservative financial statements (Utami & Irawan, 2022). Theory *Stewardship* also emphasizes that the organization's success is closely related to the satisfaction of capital owners. *Stewards* will effectively maximize the company's performance to achieve these goals.

This theory implies that the CEO, as *Steward*, must manage resources, funds, and strategies appropriately to support effective and responsible financial management. The key to implementing this responsibility lies in the ability of human resources (HR) and a reliable monetary system so that accounting reporting is reliable and profitable for stakeholders (Raharjo, 2007).

Signalling Theory

Signal Theory says that companies are encouraged to disclose their data to outsiders, such as investors and creditors, to reduce the asymmetry of existing information (Hatnawati & Irwansyah, 2022). Management (*Agent*) must submit accurate and precise financial statements to capital owners (primary) in this context. The information the management provides is a positive signal indicating that the financial statements presented are high quality and reliable ((Zahri & Kusumastuti, 2020).

The implementation of signal theory in this study is related to using *prudence accounting* principles in financial statements. This principle ensures that the company only receives resources and profits, as well as debts and losses that may occur. Thus, the resulting financial statements tend to be conservative, reduce the risk of uncertainty, and build the trust of external parties.

Prudent financial statements from management are expected to attract investors to invest in the company. As a result of this increase in investment, the number of stock trades will increase, thereby lifting the stock market value and increasing the organization's value. Therefore, signal theory supports the importance of precise and transparent information disclosure to maintain investor confidence and ensure the stability of companies in the market (Ratnasari et al., 2020).

Prudence Accounting

Prudence accounting is an accounting concept that replaces conservatism and converges with IFRS. This concept requires that revenue recognition be done carefully, even if it still has potential, by the provisions of revenue recognition (Aristiani et al., 2017). Although the IASB does not consider the principle of *caution* or conservatism as the desired quality in accounting information, the principle of *caution* is still applied when dealing with uncertainty in financial statements. PSAK No. 14 and PSAK No. 48 are examples of standards that adopt this principle.

Financial Distress

The deterioration of an organization's financial situation before economic losses or liquidation is also known as a financial crisis (*Financial Distress*). This condition arises when the cash flow of business operations is insufficient to meet its obligations, such as debt or interest payments, thus requiring corrective action (Arifin, 2018). Companies that experience *financial distress* will usually show wrong numbers in their statement of net income, operating profit, and book value of their equity (Brigham, 2010)

Free Cash Flow

Free cash flow (FCF) is a company's cash surplus after covering operating expenses and investing in fixed and current assets. FCF is discretionary cash that can pay the debt, increase investments, take treasury shares, or strengthen a company's liquidity (Sugiharto & Hendratno, 2022). The main components of the calculation of *free cash flow* include Operating cash flow, net capital expenditure, and Fluctuating working capital. Overall, FCF is a financial measure that shows the amount of cash available to stakeholders and creditors after the company meets its obligations and makes the necessary investments.

Capital Intensity

How much capital a company requires to earn profits is referred to as capital intensity. It shows the potential of the business in the industry competition (Susanto & Ramadhani, 2016). High political costs can lead to decreased profits for companies with much capital. Ratio Capital intensity refers to a company's investment in fixed assets such as property, machinery, and property against total assets. It is hoped that companies with large capital can earn significant profits.

In the context of positive accounting theory, capital intensity is considered one of the metrics of the Political Cost Hypothesis. Large industries usually have more Government

oversight because of the amount of assets used to generate profits. Therefore, companies with a lot of capital must pay attention to their financial statements to minimize significant political costs (Suprihatin, 2019).

Capital intensity can be calculated by comparing a company's fixed assets, such as property, equipment, and machinery, to the company's total assets. By a study conducted by Hotimah & Retnani (2018), the formula for measuring capital intensity is:

$$\text{Capital Intensity} = \frac{\text{Fixed Assets}}{\text{Total Assets}}$$

This ratio indicates the extent to which fixed assets make up a company's total assets and how effectively the business uses its capital to generate profits. A high ratio indicates that the industry has a significant capital intensity, which can be an essential factor in a company's competitive strategy in the market.

Framework of Thought

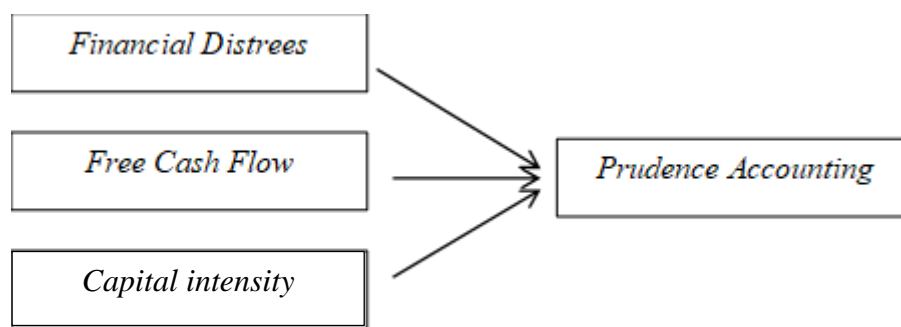


Figure 1 Theoretical framework

Hypothesis Development

H1: *Financial distress* has a positive influence on *prudence accounting*.

H2: *Free cash flow* has a positive influence on *prudence accounting*.

H3: *Capital intensity* has a positive influence on *prudence accounting*.

RESEARCH METHODS

Population and Sample

The data for this study includes financial statements from mining and mineral companies listed on the Indonesia Stock Exchange (IDX) between 2019 and 2022, covering 57 companies over four years, which resulted in 228 observational data. Data was obtained from secondary sources, specifically from <https://www.idx.co.id>.

The study used *purposive sampling* based on specific requirements (Suggestion, 2022). For this study, the following considerations or standards are used:

1. Companies in the Metal & Mineral Mining *subsector* listed on the Indonesia Stock Exchange from 2019 to 2022.
2. Metal & Mineral Mining *subsector* companies must publish complete financial statements for 2019 to 2022.
3. From 2019 to 2022 delisted companies in the Metal & Mineral Mining *subsector* were listed on the Indonesia Stock Exchange.

Data Analysis Techniques

Descriptive Analysis

Descriptive analysis is a strategy to interpret data through descriptive methods or by showing facts obtained without intending to draw broad conclusions or generalizations (Suggestion, 2022). The study determined the lowest, highest, mean, and standard deviation outcomes for each variable analyzed. It provides a basic summary of the data.

Classical Assumption Test

a. Test of Normality

The data normality test determines whether the distribution of variables used in the regression model is normal, bound, or free. The normality of the data can be shown through histogram images, but the patterns sometimes do not match the normal curves, making it difficult to know (Winarno, 2015).

b. Multicollinearity Test

Multicollinearity tests are used to determine whether or not there is a relationship between *independent variables* in the regression model. The regression model does not have a multicollinearity problem if a relationship is found. The correlation coefficient of each independent variable must exceed or be proportional to 0.8 to determine whether there is multicollinearity. If the value is lower than 0.8, there is no multicollinearity.

c. Heteroscedasticity Test

The heteroscedasticity test determines whether the regression model has an uneven residual variance, meaning that the residual variance is not the same across all observations (Priyant, 2018). If the residual variance is consistent across observations, this is known as homoskedasticity. On the contrary, the condition that shows a difference in variance is called heteroskedasticity. An effective regression model shows homoscedasticity. One of the

methods used to detect heteroscedasticity is graph analysis. Graphs with specific patterns, such as linear, quadratic, or others, can show heteroscedasticity forces. Conversely, if the graph does not show a particular pattern, then heteroscedasticity does not exist. Test *White* is an additional method that uses the following requirements:

1. In cases where the significance value (sig) is less than 0.05, the variant indicates heteroscedasticity.
2. There is no heteroscedasticity in cases where the value (sig) is more significant than 0.05.

d. Autocorrelation Test

Autocorrelation, or serial correlation, shows the relationship between values in a series of times. The ideal regression model does not contain autocorrelation. The Breusch-Godfrey approach, a variant of the Durbin-Watson method, also known as the *Lagrange Multiplier* (LM), is used to determine the presence of autocorrelation. The probability of detecting autocorrelation is calculated using the R-squared coefficient. Autocorrelation was found when the probability was less than 0.05; however, it was not found if it was higher than 0.05.

Determination Coefficient (R²) Test

The determination coefficient (R²), used in regression models with panel data, shows how far changes in independent *variables* can affect differences in dependent *variables*. Priyatno (2019) recommends using modified R² to calculate the value of the determination coefficient for several independent variables. The value of R² is between 0 and 1 because if R² = 0, the independent variable has no impact on the dependent *variable*, and if R² = 1, the independent variable ultimately influences the dependent *variable*.

Hypothesis Testing

a. Uji Goodness of Fit

A fit test, also known as a feasibility test, evaluates how well the regression function used in the sample can statistically accurately estimate the actual value (Ghozali, 2013). The assessment of the Goodness of the fit model is generally done by looking at the statistical value of F. All test results are based on the Significance value (Sig). A Significance value of less than 0.05 explains the model is recognized and feasible to be conducted in this study. If the Sig value is more significant than 0.05, it explains that the model is unsuitable for this study.

b. Partial Test (T-Test)

The T-test, called the partial regression coefficient test, checks whether any of the *variables'* independence significantly impacts the dependent *variable* (Priyatna, 2017). This test aims to test hypotheses regarding the impact of ESG disclosure and dividend policy on company performance separately. Likewise, the T-test can help evaluate the role of each *variable* independent of *the variable* dependent.

RESULTS AND DISCUSSION

Organizations listed on the Indonesia Stock Exchange in the metal and mineral mining sector are the subject of this study, with the main types of stocks from 2019 to 2022. The number of companies is 46 companies. Based on the earlier provisions, 46 companies were sampled for this study. This study examines the impact of economic difficulties, free cash flow, and capital intensity on prudent accounting. This study uses a purposive sampling strategy. The study uses the following criteria:

Table 2.
Sample Selection Criteria

No.	Criteria	Total
1	Metal and Mineral Mining Subsector Companies listed on the Indonesia Stock Exchange in 2019-2022	57
2	Metal and Mineral Mining Subsector Companies that did not fully publish their financial reports during 2019-2022	(11)
3	Metal and Mineral Mining Subsector Companies delisted from the Indonesia Stock Exchange during 2019-2022	0
Total Sample Companies		46
Research Period 2019-2022		4
Total Research Observations		184

Descriptive Analysis

Table 3
Descriptive Analysis Recapitulation

No	Keterangan	<i>Prudence Accounting</i>	<i>Financial Distress</i>	<i>Free Cash Flow</i>	Intensitas Modal
1	<i>Mean</i>	-0.552337	44.19772	3.606630	0.420054
2	<i>Maximum</i>	11.84000	2323.390	163.5900	4.360000
3	<i>Minimum</i>	-18.62000	-8.63000	-13.52000	0.20000
4	<i>Std. Dev.</i>	3.622080	255.6788	16.32781	0.389801
5	<i>Observations</i>	180	180	180	180

The results of the descriptive analysis in Table 3 reveal that the *prudence accounting* variable has a minimum value of -18.62000 and a maximum value of 11.84000, the average is -0.552337 and the standard deviation is 3.622080, which indicates significant data deviation. The minimum value for the *financial distress* variable is -8.63000, and the maximum is 2323.390, with an average of -44.19772 and a standard deviation of 255.6788, signaling a massive difference between the minimum and maximum data. The *free cash flow* variable shows a minimum value of -13.52000 and a maximum of 163.59000, an average of -3.606630 with a standard deviation of 16.32781, showing a reasonably high variation in data. Finally, the modal intensity variable has a standard deviation of 0.389801 and an average of -0.420054, indicating a less-than-average data deviation. The minimum value is 0.20000, and the maximum value is 4.360000.

Classical Assumption Test

Test of Normality

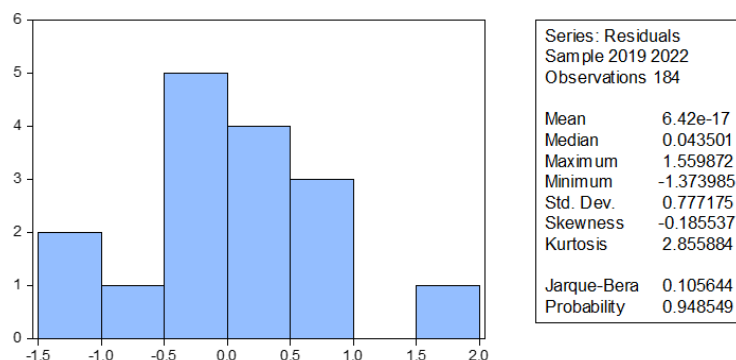


Figure 2
Normality Test Results

The normality test issued, as shown in Figure 2, explains if H0 is accepted and Ha is rejected. This indicates that the data is evenly distributed, and the regression model can be retested on the normality test.

Autocorrelation Test

Table 4
Autocorrelation Test Results

Breusch-Godfrey Serial Correlation LM Test:

F-statistic	0.708007	Prob. F(2,178)	0.4940
Obs*R-squared	1.452193	Prob. Chi-Square(2)	0.4838

According to *Table 4*, the autocorrelation test results explain that H0 can be recognized and Ha is rejected, considering that the data from *Obs*R-squared Prob Chi-Square* is 0.4838 > 0.05. This indicates that the study data does not show an autocorrelation in the regression model.

Multicollinearity Test

Table 5
Multicollinearity Test Results

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	0.143831	2.249905	NA
FD	9.89E-07	1.036651	1.005449
FCF	0.000275	1.196663	1.140702
IM	0.482853	2.474139	1.141422

No independent *variable* has an inflation difference factor (VIF) value below 10, as shown in the findings of the multicollinearity test, which can be seen in *Table 5*. As a result, it can be concluded that there is no evidence of multicollinearity in each independent *variable* in the regression model.

Heteroscedasticity Test

Table 6
Heteroscedasticity Test Results

Heteroskedasticity Test: White

F-statistic	1.633741	Prob. F(9,6)	0.2832
Obs*R-squared	11.36314	Prob. Chi-Square(9)	0.2516
Scaled explained SS	5.931190	Prob. Chi-Square(9)	0.7468

According to the heteroscedasticity test results in Table 6, we are considering the data from *Obs*R-quadratic Prob. The Chi-Square* is $0.2516 > 0.05$, indicating that H_0 is recognized and H_a is rejected. In short, heteroscedasticity does not occur in regression models.

Determination Coefficient (R²) Model

Table 7
Results of the Determination Coefficient Test

R-squared	0.834043	Mean dependent var	-0.451283
Adjusted R-squared	0.819611	S.D. dependent var	3.442074
S.E. of regression	3.229666	Sum squared resid	1877.534
F-statistic	8.287536	Durbin-Watson stat	2.201326
Prob(F-statistic)	0.000000		
Unweighted Statistics			
R-squared	0.117333	Mean dependent var	-0.552059
Sum squared resid	2119.126	Durbin-Watson stat	1.950362

The determination test (R²) results indicate an adjusted R-squared value of 0.819611, as listed in Table 7. This data shows that free cash flow, financial difficulties, and capital intensity can cause 81% variations in accounting prudence variables. The remaining 19% is affected by *variables* not listed in this study.

Hypothesis Testing

Goodness of Fit *Influence Test*

Table 8
F Test Result

R-squared	0.834043	Mean dependent var	-0.451283
Adjusted R-squared	0.819611	S.D. dependent var	3.442074
S.E. of regression	3.229666	Sum squared resid	1877.534
F-statistic	8.287536	Durbin-Watson stat	2.201326
Prob(F-statistic)	0.000000		
Unweighted Statistics			
R-squared	0.117333	Mean dependent var	-0.552059
Sum squared resid	2119.126	Durbin-Watson stat	1.950362

Table 8 shows the results of the F test; data are generated if the value of F is 8.287536 with a significance of 0.000000. In the F table of the 5% significant level with $df_1 = \text{number of variables} - 1 = 4 - 1 = 3$ and $df_2 = \text{number of samples (n)} - \text{number of independent variables (k)} = 184 - 4 = 180$, the result of obtaining the F_{table} is 2.65. The value of F_{cal} 8.077051 $> F_{table}$ 2.65 with a probability value of $0.000000 < 0.05$ so that H_0 is rejected, and H_a is recognized. Thus, the capital is feasible/*fit*.

Partial Influence Test (t-Test)

Table 9
Partial Test Results (t-Test)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.53109	0.133450	3.979708	0.0001
FD?	0.00165	0.000520	3.169231	0.0018
FCF?	0.07900	0.016087	4.910549	0.0000
IM?	0.90489	0.230345	3.928412	0.0001

Table 9 shows that if *the variable financial distress to prudence accounting* is 3.169231, the significance level is 0.05, and the freedom level $df = n - k = 184 - 4 = 180$ is obtained from table 1.97323 to know that the count value exceeds that of the table ($3.169231 > 1.97323$). As a result, H_a can be recognized, and H_0 is rejected. In short, *financial distress* has a significant positive impact on *prudence accounting*.

The variable of *free cash flow for prudence accounting with a statistical value (kcal)* of 4.910549, a significant level of 0.05, and a free level $df = n - k = 184 - 4 = 180$ were obtained in table 1.97323 to find out that the local value exceeded that of the table ($4.910549 > 1.97323$) as a result of which H_a could be recognized, and H_0 was rejected. In short, *free cash flow* has a significant positive impact on *prudence accounting*.

The capital intensity variable for *prudence accounting has a statistical value (calculate)* of 3.928412, a significant level of 0.05, and a degree of freedom $df = n - k = 184 - 4 = 180$ obtained in table 1.97323 to find out that the value of *calculated* is less than *stable* ($3.928412 > 1.97323$) as a result H_a can be recognized, and H_0 is rejected. In short, capital intensity has a significant positive impact on *prudence accounting*.

Discussion

According to the test results, economic problems positively impact *prudence accounting*. This means managers must strictly adhere to good accounting practices as financial distress increases. This applies to companies listed on the Indonesia Stock Exchange from 2019 to 2022 in the metal and mineral mining subsector. *Financial distress* triggers managers to be more careful in managing assets and risks, using *prudent accounting principles* to reduce the potential for overstatement of profits or asset values.

The study's results explain that free cash increases *prudence in accounting*. In a situation with a lot of free cash flow, the level of Prudence in accounting may increase. This applies to companies listed on the Indonesia Stock Exchange from 2019 to 2022 in the metals and minerals mining subsector. Organizations with high levels of free cash flow are likely to

allocate more resources to *prudent accounting principles*, including profit management and political expenses.

According to the test results, capital intensity impacts *prudence accounting*. This indicates that if the capital intensity is high, the level of *prudence accounting* is higher. This applies to companies listed on the Indonesia Stock Exchange from 2019 to 2022 in the metals and minerals mining subsector. Organizations with high capital levels usually apply *prudence accounting* principles to manage political costs and improve financial ratios.

CONCLUSIONS AND SUGGESTIONS

Conclusion

This study aims to explain the impact of *financial distress*, *free cash flow*, and capital intensity on *prudence accounting* in companies listed on the Indonesia Stock Exchange from 2019 to 2022 in the metal and mineral mining subsector. The following are the results of hypothesis testing obtained through panel data regression analysis:

- a. *Financial distress*, *free cash flow*, and capital intensity affect *prudence accounting*. This means an increase will follow *every change in these variables in prudence accounting*.
- b. *Financial distress* has a significant positive impact on *prudence accounting*. In short, the increase in *financial distress* also increases *the company's prudence accounting*. Likewise, vice versa, the lower *the economic distress*, the lower the *prudence accounting* carried out in the company.
- c. *Free cash flow* has a significant positive impact on *prudence accounting*. The larger the free cash flow, the more *prudence accounting* is applied. Similarly, the smaller the free cash flow, the less conservative a company's accounting practices are.
- d. Capital intensity has a significant positive impact on *prudence accounting*. This shows that the higher the capital intensity, the more *prudence accounting is applied*. Similarly, the lower the capital intensity, the lower the company's accounting prudence.

Limitations and Suggestions

a. For Companies:

1. Companies must pay attention to asset management to avoid *financial distress*. They must diversify their asset portfolio and maintain physical assets regularly. Periodic evaluations of debt performance and use are also essential to strengthen the capital position without harming the company.
2. To maximize free cash flow, companies should increase sales and cash flow and allocate funds for long-term projects, debt repayment, infrastructure improvements, and sustainability initiatives. This will improve financial stability and support sustainable growth.
3. Companies must save on operational costs, update production equipment regularly, and innovate products to keep up with market price declines, reducing the risk of losses.

b. For the next researcher

1. Increase the observation period to obtain more varied data and improve test results.
2. Research *prudence* in other sectors for more varied research results.
3. Consider including other *variables* such as *growth opportunities*, administrative ownership, organizational ownership, appraisal commissions, and organizational risk as factors affecting *Prudence*.

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