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Research Article

Accounting Conservatism as a Protective Mechanism: Exploring Its Impact on the Relationship Between Financial Decisions and Likelihood of Financial Distress in Emerging Economies

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Abstract

Purpose- This study investigates the moderating role of accounting conservatism in the relationship between corporate financial decisions (financial leverage, investment rate, and dividend payout policy) and the likelihood of financial distress among firms listed on the Kenyan Securities Exchange.

Design/Methodology- The study analyzed a sample of 45 firms over 14 years from 2008 to 2021, resulting in 630 firm-year observations. Panel logistic regression was employed to assess secondary data from annual financial reports.

Findings- Results reveal that financial leverage and investment rate significantly increase financial distress risk, while dividend payout policy has a negative effect. Accounting conservatism moderates these relationships by reducing the impact of financial leverage and enhancing the effect of dividend policy.

Practical Implications- Managers should implement conservative accounting practices to align incentives with long-term shareholder interests, ensuring prudent financial reporting and minimizing financial distress risks.

Originality- This research contributes to the understanding of financial decisions and distress, offering insights into the role of accounting conservatism in promoting corporate financial stability.

Introduction

Across the globe, many publicly traded companies have experienced financial difficulties, as seen in defaults on their financial obligations, shrinking assets, undergoing economic restructuring, and, in some cases, being placed under receivership before eventually being removed from stock markets, (Shahwan & Habib, 2020). Technological advancement and rapid business environmental changes are changing how corporate entities and other businesses conduct their activities (Chen et al., 2020). Geng et al. (2015) and Geng et al. (2015) defined financial distress as a situation where a company cannot pay its obligations or debt when due. When a company cannot pay creditors and other duties as and when it falls due, it implies that the company is struggling to generate cash and cash equivalent which are normally used to address the company's immediate and future financial needs (Ninh et al., 2018). Farooq and Noor (2021) argue that a firm is in financial distress when it fails to meet its debt obligations when it becomes due. According to Younas et al. (2021) and Khurshid et al. (2019) financial distress is usually regarded as the embarrassing situation of not being able to pay mature debts or expenses due to liquidity problems, insufficiency of equity, default debts and lack of current assets to generate sufficient cash to meet these obligations and ultimately forcing the firm into bankruptcy (Prasetyanto et al., 2021; Younas et al., 2021).

Financial distress has impacted numerous companies globally, limiting their ability to meet short- and long-term obligations (Furceri & Mourougane, 2009; Habib et al., 2013). The risks businesses face today, including the previous financial crisis and the COVID-19 pandemic, threaten many organizations' survival (Shahwan & Habib, 2020). In the U.S., major firms like Enron, Lehman Brothers, and General Motors have faced distress, while European companies such as Swiss Air and Marks & Spencer, and firms in Asia-Pacific like Pacific Gas & Electric and Jet Airways, are also struggling (Khurshid et al., 2019; Mukoma, 2020).

In developing economies, financial distress varies cyclically. A KPMG survey revealed that nonperforming loans in Germany rose from €100 billion in 2005 to €150.3 billion in 2007. Research in Egypt found that 31% of firms faced financial difficulties, reflecting high reliance on debt for funding (Shahwan & Habib, 2020). Several African firms, including South Africa's ESKOM and Nigeria's Arik Airlines, also face distress (Shahwan & Habib, 2020). Corporate financial decisions like debt usage (financial leverage), long-term investments, and dividend payout policies are key contributors to distress, as these decisions signal market perceptions (Eldomiaty et al., 2019). During crises like COVID-19, these decisions can increase distress risk (Andriosopoulos et al., 2021). Excessive payouts are linked to higher distress and lower survival rates (Andriosopoulos et al., 2021).

The static trade-off theory suggests that higher leverage is linked to less distress, while the pecking order theory posits the opposite (Myers, 1977). Research shows leverage generally increases distress risk (George & Hwang, 2010), although some studies report mixed results (John & John, 1993; Masdupi et al., 2018). Corporate investment also influences financial performance, with investments in long-term assets posing significant risks during economic downturns. High investment rates can increase distress (Männasoo et al., 2018). Mixed findings exist regarding capital investment's impact on distress, with some studies finding positive relationships (Zhang, 2015), while others find no effect (ALShubiri, 2011).

Dividend payout policies are closely tied to capital investment decisions, as paying dividends reduces the cash available for investments, potentially increasing financial distress (Easterbrook, 1984; Ross, 1977). While higher dividend payouts may signal expected profits, they also raise financial risk by limiting investment funds, leading to increased reliance on debt. Corporate investments, essential for productivity and competitiveness, involve significant risks, particularly when financed through debt. Repaying debt can strain cash flows, and productivity gains from investments may take time to materialize. In some cases, investments may even yield negative returns

(Maripuu & Männasoo, 2014). Additionally, investments in long-term assets, such as technology, can lead to increased operational costs, impacting a firm's financial stability (Črnigoj & Verbič, 2014).

Agency theory (Meckling & Jensen, 1976) highlights conflicts between managers and principals that affect investment decisions. Managers may engage in "empire-building," investing in risky projects to expand control, which can increase financial distress. However, financial leverage can mitigate this by reducing the funds available for excessive investments (Jensen, 1986). Research shows mixed results on the impact of high capital investment on financial distress, with some studies indicating a positive relationship (Ijaz et al.; Zhang, 2015) while others show no significant impact (ALShubiri, 2011; Croce et al., 2015).

Dividend policy is another important decision, with conflicting effects on financial distress. Higher payouts can reduce agency costs by limiting managerial discretion over cash, but they also reduce available funds for investments, increasing distress risk (Easterbrook, 1984; Rozeff, 1982). Empirical studies suggest an inverse relationship between dividend payouts and firm growth, with higher payouts potentially leading to slower growth and greater financial distress (Amidu & Abor, 2006; He, 2012). However, in some cases, dividend policies can support growth by reducing agency conflicts (Bartram et al., 2012).

While financial decisions such as leverage, investment rate and dividend policy directly affect financial distress, accounting conservatism can help reduce this risk (Biddle et al., 2022). By recognizing losses and liabilities promptly, conservatism allows management to address potential distress earlier (Watts, 2003). Though conservative accounting reduces net income and net assets, empirical research suggests that it improves cash reserves and curbs earnings management, thus lowering the likelihood of distress, (Biddle et al., 2022). For instance, conservative accounting helps firms restructure earlier after covenant breaches, leading to better recovery rates in case of default (Carrizosa & Ryan, 2013; Donovan et al., 2015).

Research also shows that conservative accounting practices can mitigate conflicts of interest in dividend policies by reducing the risk of excessive payouts (Watts, 2003). Additionally, firms adopting conservative policies are less likely to engage in opportunistic investments, as timely loss recognition reduces incentives for earnings manipulation (Ball & Shivakumar, 2005). This promotes better decision-making and reduces financial distress risk.

Previous studies suggest that both short-term debt and accounting conservatism help mitigate agency costs by increasing external oversight and ensuring earlier recognition of financial distress risk (Khurana & Wang, 2015). Conservative accounting also limits managerial discretion, encouraging them to prioritize debt repayment and improve cash flow management (Biddle et al., 2022).

In conclusion, while financial decisions like leverage, investment rate, and dividend policy influence the likelihood of financial distress, accounting conservatism plays a moderating role by reducing distress risks through early loss recognition and improved cash management. This study aims to explore this moderating effect, particularly in firms listed on the Nairobi Securities Exchange (NSE), where the relationship between financial decisions and financial distress has not been empirically examined.

Literature Review

Theoretical review

Agency Theory

Developed by Meckling and Jensen (1976), Agency Theory highlights conflicts of interest between managers and shareholders due to the separation of ownership and control. Managers may prioritize personal gains, such as pursuing risky investments or financing unproductive projects, which could lead to financial distress

(Männasoo et al., 2018). Accounting conservatism can moderate this by reducing managers' ability to engage in earnings manipulation, thus aligning their interests with those of shareholders (Christensen et al., 2015; Harris & Raviv, 1988).

Empirical studies support that increased leverage can reduce agency costs by pressuring managers to align their actions with shareholders' interests. For instance, high leverage can reduce agency costs by introducing the threat of liquidation, leading to increased firm value and better financial performance (Grossman & Hart, 1982; Guney & Ozkan*, 2005). This relationship has been explored extensively, linking higher debt to improved efficiency and profitability in both U.S. and international contexts (Clayton et al., 2015; Roden & Lewellen, 1995).

Positive Accounting Theory (PAT)

PAT, developed by Watts and Zimmerman (1990), aims to predict and explain managers' accounting choices based on self-interest. Under PAT, managers of highly leveraged firms may adopt accounting methods to shift earnings and meet debt covenants, which can increase the likelihood of financial distress. However, accounting conservatism serves as a moderating tool, enforcing the prompt recognition of liabilities and preventing earnings management that could distort the company's financial health.

Conservative accounting practices ensure that managers provide a realistic portrayal of financial conditions, aligning investments with shareholder interests and reducing the risk of distress. PAT suggests that managers might use dividends as a signaling mechanism to indicate firm stability, but this may jeopardize liquidity. Accounting conservatism helps mitigate these risks by ensuring dividends are based on real profits, reducing financial distress.

PAT also predicts that larger firms and those with high debt-equity ratios are more likely to use accounting methods that shift earnings across periods. In an unregulated market, firms adopt audited financial statements to reduce agency costs, ensuring transparency and accountability. Similarly, regulatory environments shape accounting practices, with political processes influencing financial reporting decisions. As regulation expands, demand for accounting theories increases, providing justifications for various corporate strategies, including rate-setting and antitrust decisions (Watts & Zimmerman, 1990).

Empirical review

Financial Leverage and Financial Distress

Financial leverage involves using borrowed funds to enhance investment returns, with companies balancing debt and equity to optimize operations (Chen & Chen, 2011; Fabozzi & Drake, 2009). However, excessive debt can lead to financial distress when cash flows are insufficient to cover obligations, with larger interest payments eroding profitability (Bhaskar et al., 2017). High leverage also heightens financial risk, reducing a company's flexibility and increasing its vulnerability to distress (Acharya et al., 2017). Studies confirm that higher leverage generally worsens financial challenges, particularly in sectors like hospitality (Lee et al., 2011; Mandelker & Rhee, 1984). While some researchers, like Jensen (1989), argue that leverage can bring organizational benefits, most findings suggest it elevates risk (Jaafar et al., 2020; Rajan & Zingales, 1995).

Research links financial leverage to financial distress, with high leverage increasing risk (Altman et al., 2019; Garman & Ohlson, 1980). Various studies across sectors, such as Frank and Goyal (2008) and, (El-Sayed Ebaid, 2009); Turaboğlu et al. (2017) confirm that excessive debt raises the likelihood of financial trouble. Yet, results are mixed; while some studies find leverage negatively impacts distress, others report no significant effect (El-Sayed Ebaid, 2009; Muigai & Muriithi, 2017). Overall, high leverage is frequently associated with financial

difficulties, particularly in developing countries where financial structures are often less stable (Lee et al., 2011; Muigai & Muriithi, 2017).

Investment Rate and Financial Distress

Investment decisions are crucial for managing a company's risk of financial distress. Poor investment choices can reduce cash flow, harming profitability and increasing financial strain, especially when funded through debt (Ahmadi & Kordloei, 2018). Well-planned investments can support long-term financial health, while overinvestment risks financial distress by generating low returns (Garcia-Appendini, 2018). The balance between leveraging external capital for investments and maintaining liquidity is key, particularly in uncertain economic conditions (López-Gutiérrez et al., 2015; Ogawa, 2003).

Agency theory highlights conflicts between managers and shareholders that can drive risky investments, like over-investment in projects with uncertain returns (Baumol, 1962; Bolton et al., 2013). On the other hand, high leverage can curb overinvestment by limiting available cash flow (Jensen, 1986). Research shows that investment decisions, particularly in current assets, significantly impact growth and performance (Carpenter et al., 1994), but market imperfections can hinder optimal investment strategies (Modigliani & Miller, 1958). While some studies find a strong link between investment and distress (Männasoo et al., 2018), others offer conflicting evidence (Morgado & Pindado, 2003).

Credit constraints further complicate the investment-distress relationship, particularly for smaller firms, making external financing critical for avoiding distress (Carpenter et al., 1994). Firms in financial distress also tend to invest less and face higher leverage, slower growth, and reduced liquidity (Bhagat et al., 2005). Investment decisions, especially during economic downturns, can either mitigate or exacerbate financial challenges, with careful capital allocation being vital for long-term survival (Campello et al., 2011; Popov, 2014).

Dividend payout policy and Financial Distress

A dividend payout policy balances profits distributed to shareholders with those retained for investments, influencing a firm's financial health. High dividend payouts can increase financial distress by limiting funds for debt payments and growth, while lower payouts help maintain financial stability (López-Gutiérrez et al., 2015; Sa'diyah & Widagdo, 2022). Three key theories address dividends: the irrelevance theory, which suggests dividend policy doesn't impact financial distress in perfect markets; the bird-in-the-hand theory, which argues dividends boost shareholder wealth; and agency theory, which sees dividends as reducing conflicts between shareholders and managers (Gordon, 1963; Meckling & Jensen, 1976). Dividend decisions also impact firm liquidity, market value, and growth, with ownership structure playing a role in payout levels (La Porta et al., 2000; Rozeff, 1982). Understanding these factors is essential for managing agency costs and mitigating financial distress.

Moderation effect of accounting conservatism

Accounting conservatism involves cautious financial reporting, requiring companies to recognize potential losses early while delaying the recognition of uncertain profits. This approach helps improve the accuracy of financial statements and rebuild public trust in financial reporting, especially during crises like the 2008 financial crisis or the COVID-19 pandemic (Ruch & Taylor, 2015; Zhong & Li, 2017). Conservatism aids firms in managing financial decisions—such as capital expenditures, financing, and dividend policies—that could lead to distress if not properly handled (Lafond & Roychowdhury, 2008). By providing a more conservative view of a company's financial health, conservatism enhances credibility and acts as an early warning system for financial distress, helping businesses conserve cash and avoid overvaluing assets (Yusnaini & Tarmizi, 2019).

Accounting conservatism comes in two forms: conditional, which responds to economic changes by promptly recognizing negative financial events, and unconditional, which consistently undervalues net assets. Both forms

play a critical role in reducing financial distress by promoting conservative financial management, limiting earnings manipulation, and increasing cash reserves (Beaver & Ryan, 2005). For example, conservative practices can reduce dividends during difficult times, conserving cash that can be used to cover debt obligations and prevent over-investment in failing projects (Ahmed & Duellman, 2013; Nikolaev, 2010). By building up reserves during good times, conservatism also provides a buffer for economic downturns.

Research suggests that while conservatism lowers reported profits and asset values, it ultimately reduces bankruptcy risk by increasing liquidity and cash reserves. Cash shortages, not a lack of profit, are the primary cause of bankruptcy. Conservative accounting helps firms accumulate cash reserves, manage debt payments, and improve the terms of debt renegotiations (Sunder et al., 2018). Additionally, by requiring firms to recognize bad news earlier, conservatism can trigger debt covenant violations sooner, allowing quicker intervention to resolve financial issues and improve recovery rates during defaults (Carrizosa & Ryan, 2013; Gong & Luo, 2018).

Conservatism also acts as a safeguard against excessive risk-taking by management, aligning interests between shareholders and debtholders. It reduces information asymmetry, curbs agency conflicts, and limits earnings manipulation, making it harder for managers to hide poor financial performance (Biddle et al., 2022; Meckling & Jensen, 1976). Studies show that conservative financial reporting, especially conditional conservatism, supports long-term financial health by ensuring that financial statements reflect a company's true economic position (Lafond & Roychowdhury, 2008).

Furthermore, conservatism can enhance firms' access to external capital by improving debt contracts and reducing uncertainty around financial performance (Ball & Shivakumar, 2005). Conservative reporting practices set lower thresholds for asset valuation, helping firms secure capital more easily during times of distress (Sunder et al., 2018). By limiting earnings management and providing more accurate reporting, conservatism improves firms' ability to meet debt obligations and avoid technical defaults (Nikolaev, 2010; Tan, 2013). While some critics argue that conservatism may encourage overly cautious financial behavior, research supports its role in promoting financial stability by enhancing cash flow management, reducing unnecessary expenses, and preserving long-term shareholder value (Biddle et al., 2022).

Overall, accounting conservatism helps reduce the risk of financial distress by improving cash reserves, limiting risky investments, and ensuring more accurate financial reporting. Its conservative stance provides a buffer against economic downturns, enhances the firm's ability to manage debt, and reduces agency costs, all of which contribute to a firm's financial resilience and stability (Watts, 2003; Zhong & Li, 2017).

Control Variables

Firm size

The study suggests a negative relationship between firm size and financial distress, as larger firms benefit from economies of scale and greater resources, which help them withstand financial challenges (Bhattacharjee & Han, 2014; Yazdanfar & Öhman, 2020).

Firm age

Similarly, firm age is negatively associated with financial distress, as older firms are better equipped to handle regulatory demands and have a lower failure risk (Beasley, 1996; Evans, 1987). Firm age, measured in years, reflects how long a firm has been publicly traded, with newer companies facing higher financial risks.

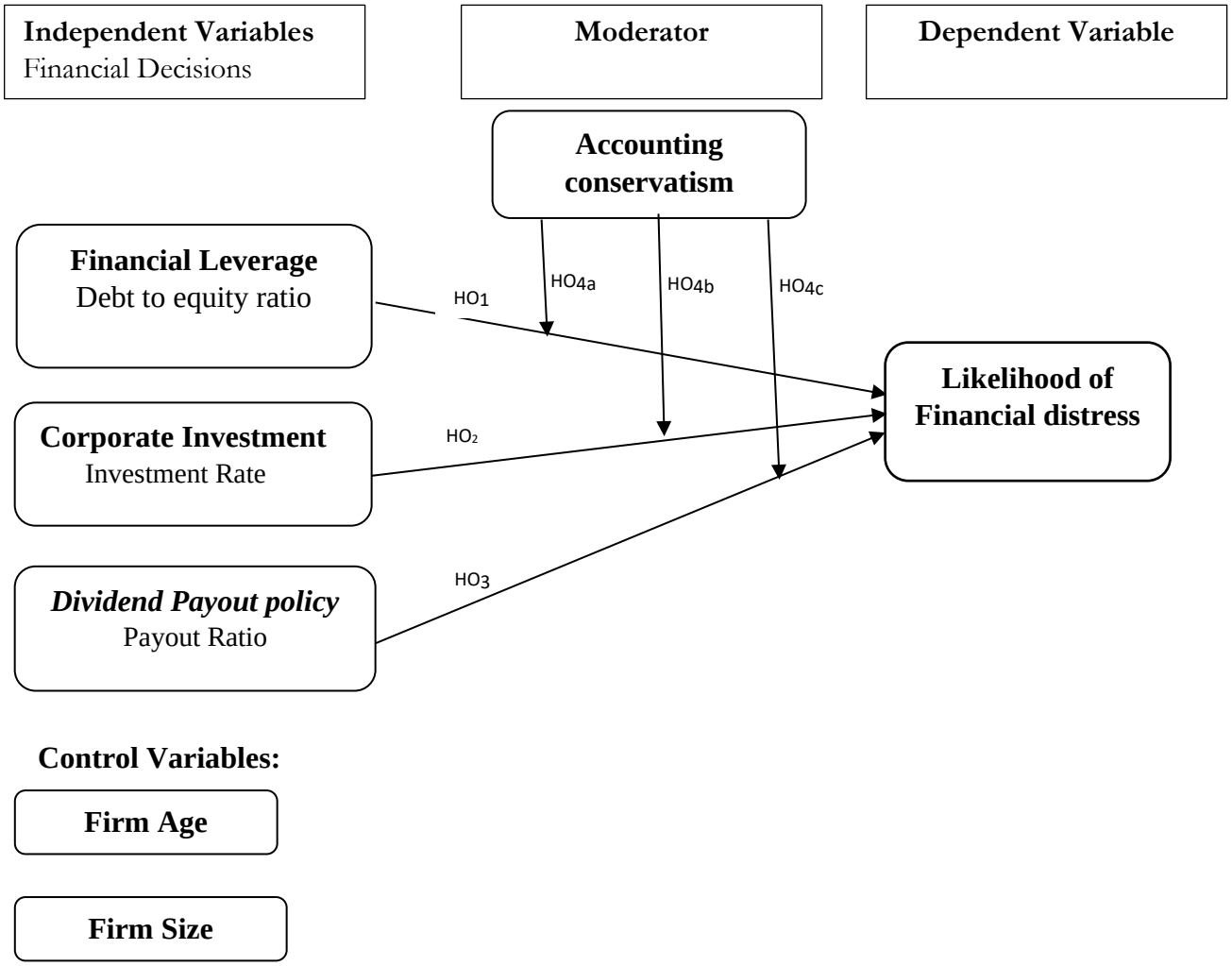

Figure 1: Conceptual framework

Model specification

logit(p)it = β0 +β1$SIZEit$ +β2$AGEit$ + ……..……...…….model 1

logit(p)it = β0 +β1$SIZEit$ +β2$AGEit$ +β3FLit +β4INVEit+β5DPit + ...model 2

logit(p)it = β0 +β1$SIZEit$ +β2$AGEit$ +β3FLit +β4INVEit+β5DPit +β6Mit +β7FLit∗Mit+...model 3

logit(p)it= β0 +β1$SIZEit$ +β2$AGEit$ +β3FLit +β4INVEit+β5DPit +β6Mit +β7FLit∗Mit
+β8INVEit∗Mit+ ……...…….....Model 4

logit(p) it = β0 +β1$SIZEit$ +β2$AGEit$ +β3FLit +β4INVEit+β5DPit +β6Mit +β7FLit∗Mit
+β8INVEit∗Mit+β9DPit∗Mit+ …….……...……. Model 5

Where:

p =is the probability of the event occurring

logit(p) = natural logarithm of the odds of the event occurring (i.e. the logarithm of p divided by 1-p) [log[p/(1-p)]
β0 = constant
$\beta 1 \ldots \beta 11$ = regression coefficients
$SIZE$ = Firm size
AGE= Firm age
FLit = Corporate financial leverage
INVEit= Investment rate
DPit= Dividend payout Policy ratio
Mit= Accounting conservatism which is the moderator
= Error term
i = Company
t =Year

Methodology

This study employed secondary data collection methods to gather information about the variables under investigation. Panel data spanning the years 2008 to 2021 were sourced from multiple outlets, including the website of the Nairobi Securities Exchange (NSE), the Central Bank of Kenya's website, and annual published reports of listed firms. Data about corporate financial leverage, investment rates, dividend payout policies, firm assets, and firm age were derived from these sources. Additionally, information about financial distress was constructed using firm-level financial data available in the same reports.

While secondary data offers the advantage of accessibility and cost-efficiency, it is not without limitations and potential biases. First, the reliance on publicly available records introduces the risk of incomplete or inconsistent data due to variations in reporting standards across firms or missing information in certain years. Second, the data's accuracy is contingent upon the sources' reliability, and initial documentation errors could compromise the study's findings. Third, the predefined nature of secondary data restricts flexibility, as it may not perfectly align with the specific needs of the research framework. Lastly, using data from 2008 to 2021 might introduce historical biases, where macroeconomic events during this period such as global financial crises or local regulatory changes could influence the variables in ways not directly attributable to firm-specific characteristics. These limitations necessitate cautious interpretation of the findings and acknowledgment of potential confounding factors in the study's conclusions.

Results and Discussion

Descriptive results

Table 1 reveals the average descriptive results for all the variables analyzed from 1008 to 2021. These results show that 23% of firms analyzed during the period were financially distressed. The results further show that the mean investment rate is 0.116, indicating that, on average, firms invest at a rate of approximately 11.6%. The standard deviation of 0.174 suggests moderate variability in investment rates among the sample firms. Analysis of the table also indicated that the mean dividend payout ratio is 0.3512, indicating that, on average, firms pay out approximately 35.12% of their earnings as dividends. The high standard deviation (0.678) suggests considerable variability in dividend payout ratios among the sample firms. This shows the perceived importance of dividends by firms trading at NSE. In terms of accounting conservatism, the results show a negative mean value (-0.843) indicating that the majority of firms practice a conservative accounting approach among the sample firms. The standard deviation of 0.426 indicates moderate variability in accounting conservatism during the period of study.

The mean firm age during the study period was 3.976, indicating that, on average, firms in the sample were in operation for approximately 3.98 years. The standard deviation of 0.543 suggests moderate variability in firm ages. The mean firm size during the period was 7.029 and the standard deviation was 1.13 suggesting considerable variability in firm sizes among the sample firms.

Table 1 Distribution of the Mean and Standard Deviation of the Variables

Variable	Obs	Mean	Std. Dev.	Min	Max
FD	630	0.231	0.422	0.000	1.000
FL	630	2.202	3.606	-8.926	57.218
INVE	630	0.116	0.174	-0.556	0.738
DP	630	0.351	0.678	-3.571	11.111
AC	630	-0.843	0.426	-2.785	-0.196
FA	630	3.976	0.543	1.386	4.836
FS	630	7.029	1.132	3.818	9.201

FD: *likelihood of financial distress,* ***FL:*** *Financial leverage,* ***INVE:*** *Investment rate,* ***DP:*** *Dividend payout ratio,* ***AC:*** *Accounting conservatism,* ***FA:*** *Firm Age,* ***FS:*** *Firm Size,* ***P50:*** *50th percentile,* ***SD****: standard deviation,* ***Min****: minimum,* ***Max****: maximum,* ***N:*** *number of firms.*

Correlation Analysis

Correlation is a statistical metric that measures the relationship between two variables, represented by a coefficient that indicates both the direction and strength of the association. The direction can be positive or negative (VanderStoep & Johnston, 2009). This coefficient, which ranges from -1 to +1, evaluates the strength and direction of the variables' relationship. As noted by Tay (2017)), a coefficient of -1 represents a perfect negative correlation, while +1 represents a perfect positive correlation.

In this study, the Pearson correlation coefficient was applied to evaluate the strength and direction of the linear relationships between financial decisions, control variables, and financial distress. Additionally, the correlation coefficients were used to check for multicollinearity in the regression analysis, as a correlation coefficient of 0.8 or higher indicates a significant multicollinearity issue between the independent variables (Hair Jr et al., 2017). The results of the correlation analysis are provided in Table 2.

Overall, the results in Table 2 indicate no issues with multicollinearity, as all coefficients are below 0.8. Among the variables analyzed, financial leverage showed the strongest link to financial distress, followed by firm size, investment rate, firm age, accounting conservatism, and, finally, the dividend payout ratio.

The Pearson correlation findings in Table 2 specifically show that financial leverage (FL) has a positive and significant link to financial distress ($r = 0.348$, $p < 0.05$). This means that a rise in financial leverage notably increases the likelihood of financial distress. This finding aligns with earlier studies by Dirman (2020); Koh et al. (2015); Susanti et al. (2020); Wangsih et al. (2021), which also observed a significant positive relationship between financial leverage and financial distress likelihood.

The results also indicate that the investment rate (INVE) has a positive and significant relationship with financial distress ($r = 0.207$, $p < 0.05$). This suggests that the likelihood of financial distress increases significantly as the investment rate increases. These findings align with previous studies, such as those by Al-Dhamari et al. (2023), Gentry et al. (1985); Suranta et al. (2023); Zhang (2015), which found a positive and significant effect of the investment rate on the likelihood of financial distress. However, these results contradict the findings of some other studies, including, McKee and Lensberg (2002) McKee and Lensberg (2002); (Min & Lee, 2005) which reported no positive or no relationship between the investment rate and financial distress likelihood.

The correlation results further reveal that the dividend payout ratio (DP) has a negative and significant effect on the likelihood of financial distress ($r = -0.102$, $p < 0.05$). This suggests that increasing the share of dividends paid to shareholders significantly reduces the chances of financial distress. These findings align with earlier research by Ali (2022); Andriosopoulos et al. (2021); L. Cao et al. (2017); DeAngelo and DeAngelo (1990); Rivandi and Ariska (2019), which showed that dividend payouts have a negative and significant effect on the likelihood of experiencing financial distress. However, these results contradict the findings of studies by Widagdo and Sa'diyah (2022), Black and Scholes (1974); López-Gutiérrez et al. (2015); Miller and Modigliani (1961), and Miller and Modigliani (1961), reported either no significant effect or a positive significant effect of dividend policy on the likelihood of financial distress.

The study also examined the connection between accounting conservatism and financial distress. Table 2 shows a negative and significant relationship ($r = -0.102$, $p < 0.05$) between accounting conservatism and financial distress. Therefore, it can be contended that when firms adopt a high level of accounting conservatism i.e Strict application of conservative accounting, recognizing all potential liabilities, and minimizing the recognition of uncertain gains, the chances of financial distress are significantly lowered. These results are consistent with the research of Kao and Sie (2016); Putri et al. (2023); Rahayu and Gunawan (2018); Sari (2020), as well as Zhang (2008), who found that accounting conservatism has a negative and significant effect on the chances of financial distress. This is because accounting conservatism helps reduce the risk of mismanagement and unethical financial reporting, which can lead to financial distress, as highlighted by Biddle et al. (2022).

Additionally, the analysis revealed a negative and significant link between firm size and financial distress ($r = -0.271$, $p < 0.05$). This indicates that as a firm's size increases, the chances of encountering financial distress decrease. Consequently, it can be inferred that small firms are more susceptible to financial distress compared to large firms. This finding aligns with previous research, such as that conducted by Gichaiya et al. (2019); Muigai and Muriithi (2017); Nguyen (2024).

Additionally, the results demonstrated that firm age has a positive and significant correlation with financial distress ($r = 0.172$, $p < 0.05$). This suggests that as a firm ages, its probability of experiencing financial distress also rises. Hence, it can be argued that older firms are more prone to financial distress than younger firms that are still in their growth stages. This observation may be attributed to agency problems arising from the separation of ownership and management, where managers might place their interests above those of shareholders.

Table 2: Correlation results

	FD	**FA**	**FS**	**FL**	**INVE**	**DP**	**AC**
FD	1.000						
FA	0.172*	1.000					
FS	-0.271*	-0.053	1.000				
FL	0.348*	-0.053	0.299*	1.000			
INVE	0.207*	-0.045	0.243*	0.190*	1.000		
DP	-0.102*	-0.040	-0.053	-0.065	-0.024	1.000	
AC	-0.102*	0.041	0.035	-0.086*	-0.056	-0.058	1.000

***** Correlation is significant at the 0.01 level (2-tailed).***

**** Correlation is significant at the 0.05 level (2-tailed)***

FD: *likelihood of financial distress,* ***FL:*** *Financial leverage,* ***INVE:*** *Investment rate,* ***DP:*** *Dividend payout ratio,* ***AC:*** *Accounting conservatism,* ***FA****: Firm Age,* ***FS****: Firm Size*

Discussion

The primary influence and corresponding hypothesis (**H_{o1} to H_{o3}**) were examined in the second model of the panel logistic regression analysis. and the results are presented in Table 3. From these findings, it is evident that the overall logistic regression model is statistically significant based on the chi-squared test, with a low p-value of 0.0000 (*P<0.05*), indicating that it is highly unlikely that the observed relationships occurred by chance. The Wald chi2(5) is 30.55 indicating the overall significance of the model suggesting a strong group-level effect. The negative log-likelihood (-159.471) and the R-squared (0.17), suggest that the model provides a reasonably good fit of the model explaining a significant portion of the variation in financial distress. The R-square for the model was 0.17, suggesting that the predictor variables explain approximately 17% of the variation in the likelihood of financial distress among companies trading at NSE.

H_{o1}: Financial leverage does not have a significant effect on the likelihood of financial distress among corporate entities trading at NSE.

The results in Table 3 indicate that a higher level of financial leverage (more debt) is linked to a greater likelihood of financial distress ($\beta = 0.238$, $P < 0.05$). With a p-value less than 0.05, the null hypothesis (Ho), which posits that financial leverage does not significantly affect the likelihood of financial distress among firms trading on the NSE, is rejected. This leads to the conclusion that financial leverage significantly impacts the likelihood of financial distress. A positive coefficient indicates that higher leverage (more debt) is associated with increased log odds of the likelihood of financial distress. This implies that a unit increase in financial leverage increases the log odds of the likelihood of financial distress by 0.238 units. This suggests that financially healthy firms depend more on equity than debt. This is because with increasing leverage (debt-to-equity ratio), the likelihood of financial distress increases due to investors' perception of levered firms. Scholars argue that financial debts reduce financial flexibility and therefore expose the firm to financial distress risk (the reduced-flexibility hypothesis). Additionally, high debt levels can lead to higher interest expenses, which can reduce profitability and further exacerbate financial distress (Fabozzi & Drake, 2009) (Bhaskar et al., 2017). A company with a high debt-to-equity ratio may either keep a larger portion of its profits to fund debt repayment or be obligated to distribute a portion of its profits according to debt agreements to secure the funds required for debt repayment (Bhaskar et al., 2017). Firms with high debt levels often encounter limitations on their financial flexibility. They may find it challenging to adapt during economic downturns or cash flow issues, increasing their risk of financial distress. Elevated leverage results in higher interest payments, which can strain a company's cash flow. If revenues fall short of covering these expenses, the firm may face financial distress. Additionally, firms with significant debt may be bound by restrictive covenants from lenders, which can constrain their operational flexibility and financial strategies. This increases the risk of distress if they fail to adhere to these conditions.

High leverage also magnifies the effects of market fluctuations on a firm's profitability. Negative changes in market conditions can have a greater impact on highly leveraged firms, making them more prone to financial distress. Moreover, high levels of financial leverage can signal greater risk to investors and creditors, potentially leading to increased borrowing costs or reduced investment, which further heightens financial distress. Firms with substantial debt may see a drop in their credit ratings, leading to higher interest rates on new loans and greater difficulty in securing financing, thus contributing to financial distress.

The results align with prior research, for example, the studies by (Dirman, 2020; Koh et al., 2015; Susanti et al., 2020; Wangsih et al., 2021), whose studies found that financial leverage has a significant positive relationship with the likelihood of financial distress. However, the findings of the study were not in agreement with the findings of (Giarto & Fachrurrozie, 2020; Jaafar et al., 2018; Saputri & Asrori, 2019), whose studies found that leverage does not significantly increase the likelihood of financial distress. Similarly, these findings contradict

the findings from research conducted by (Finishtya, 2019) as well as (Restianti & Agustina, 2018) which found that leverage does not have a significant influence on the likelihood of financial distress.

H_{o2}: Investment rate does not have a significant effect on the likelihood of financial distress among corporate entities trading at NSE.

The results in Table 3 reveal that the investment rate significantly and positively affects the likelihood of financial distress among companies listed on the NSE ($\beta = 2.199$, $P < 0.05$). Since the p-value is below 0.05, this indicates that the impact of the investment rate on financial distress is substantial. Therefore, the null hypothesis, which suggested that the investment rate does not significantly influence the likelihood of financial distress for NSE-listed companies, is rejected. It is concluded that the investment rate does have a significant effect on financial distress among these firms. Specifically, a one-unit increase in the investment rate increases the log odds of financial distress by 2.199 units.

High investment rates often necessitate substantial capital outlays. If these investments fail to yield adequate returns, they can place significant strain on a company's financial resources, heightening the risk of distress. To fund large investments, companies may turn to debt. Increased borrowing elevates interest costs and repayment demands, which can amplify financial distress if the company's cash flow falls short. Large investments, particularly in new projects, carry inherent operational risks. Should these projects falter or underperform, the resulting financial strain can lead to distress. Additionally, high investment rates can reduce liquidity, as funds are committed to capital projects, potentially impeding the firm's ability to meet short-term obligations and increasing financial distress. Firms with high investment rates may also be more vulnerable to market fluctuations. Adverse market conditions can disproportionately affect companies with significant investments, making them more prone to financial distress. Furthermore, high investment rates often come with expectations of substantial returns. If these returns do not materialize, the discrepancy between investment costs and actual revenue can cause financial difficulties. Lastly, aggressive investment strategies can result in overexpansion. Rapid expansion without sufficient market research or operational capacity can lead to challenges, raising the risk of financial distress.

This finding aligns with agency theory, which highlights various conflicts between managers and principals that are directly related to corporate investment decisions. These conflicts can impact performance and elevate the likelihood of financial distress (Stein, 2003). Among these conflicts are the cases of over-investment, empire-building, and reputational problems, which increase the company's likelihood of financial distress (Zhang et al., 2016). All of these problems have different implications for corporate investment which ultimately increase the chance of financial distress. In addition, debt repayments on investments funded with external capital put pressure on the company's cash flows which increases the entity's likelihood of financial distress. These results are consistent with previous studies including (Al-Dhamari et al., 2023; Gentry et al., 1985; Suranta et al., 2023), Gentry et al., 1985) whose studies found that investment rate have a positive and significant effect on the likelihood of financial distress. However, these findings are not consistent with the findings of (McKee & Lensberg, 2002; Min & Lee, 2005), whose studies found no positive or no relationship between investment rate and the likelihood of financial distress.

H_{o3}: Dividend policy does not have a significant effect on the likelihood of financial distress among corporate entities trading at NSE.

Similarly, Table 3 shows that the dividend policy has a significant negative impact on the likelihood of financial distress for companies listed on the NSE ($\beta = -1.852$, $P < 0.05$). The p-value being less than 0.05 confirms that the dividend policy significantly affects financial distress. As a result, we reject the null hypothesis that the dividend policy does not have a significant effect on financial distress for NSE-listed firms. The findings suggest

that the dividend policy does significantly influence financial distress among these companies. Specifically, a one-unit increase in the dividend payout ratio lowers the log odds of financial distress by -1.852 units.

These results support agency cost theory, which argues that dividend payments reduce the conflicts between shareholders and managers (Moh'd et al., 1995). According to this theory, paying dividends signals that managers are committed to using shareholders' funds wisely rather than funneling them into risky or unprofitable ventures. Moreover, (Miller & Rock, 1985) contend that dividend payouts provide important signals about a firm's future earnings, enhancing investor confidence and thereby decreasing the likelihood of financial distress.

These results are consistent with previous studies including (Ali, 2022; Andriosopoulos et al., 2021; J. Cao et al., 2017; DeAngelo & DeAngelo, 1990; Rivandi & Ariska, 2019) whose studies found that dividend payout has a negative and significant effect on the likelihood of financial distress. However, these findings are not consistent with the findings of (Black & Scholes, 1974; López-Gutiérrez et al., 2015; Miller & Modigliani, 1961; Sa'diyah & Widagdo, 2022) whose studies found no significant effect of dividend policy or positive significant effect of dividend policy on the likelihood of financial distress.

Moderating Effect (Random effects logistic regression model)

Furthermore, the study aimed to investigate the moderating effect of accounting conservatism on the relationship between financial decisions and the likelihood of financial distress of entities trading at NSE testing hypothesis (**Ho_{4a}** to **Ho_{4c}**).

Ho_{4a}: The study examined whether accounting conservatism moderates the relationship between financial leverage and the likelihood of financial distress among firms listed on the NSE as shown in Table 3. The results indicated that the logistic regression model was a good fit (log-likelihood = -141.253, $P < 0.000$), with the R-Square value increasing to 0.264, suggesting a 6.6% improvement in explanatory power due to the interaction term.

A significant negative moderating effect of accounting conservatism was found ($\beta = -2.840$, $P < 0.05$). This implies that while financial leverage typically raises the risk of financial distress, the risk diminishes when accounting conservatism is present. Firms practicing conservatism tend to report financial stability even under high leverage, reflecting potential difficulties earlier and managing risks effectively.

Conservative financial reporting can enhance creditors' confidence, leading to favorable financing terms and reduced financial pressure. Moreover, such firms are likely to take early corrective actions to address financial issues, maintain stability, and manage their debt obligations more effectively. Overall, accounting conservatism appears to play a crucial role in mitigating the negative impacts of high financial leverage on the likelihood of financial distress.

Ho_{4b}: The study also explored whether accounting conservatism moderates the relationship between investment rate and the likelihood of financial distress among firms listed on the NSE as indicated in Table 3. The results from the logistic regression model showed a good fit (log-likelihood = -137.489, $P < 0.000$), with an R-squared value of 0.283, indicating a 1.9% increase in explanatory power from the previous model.

A significant positive moderating effect of accounting conservatism was found ($\beta = 17.518$, $P < 0.05$). This suggests that while higher investment rates generally increase the risk of financial distress, this effect is amplified when firms adopt conservative accounting practices. Specifically, conservative accounting leads to early recognition of potential investment underperformance, increasing perceived financial risk.

Firms that practice accounting conservatism often report lower profits and asset values, which may signal distress to investors, potentially impacting stock prices, creditworthiness, and capital access. This conditional conservatism means that negative economic news or poor investment performance is quickly reflected in financial statements, heightening the likelihood of financial distress when investment rates rise.

Ho_{4c}: The study further examined the moderating effect of accounting conservatism on the relationship between dividend policy and the likelihood of financial distress for firms listed on the NSE. The logistic regression results (log-likelihood = -235.917, $P < 0.000$) indicated a well-fitted model, with an R-squared value of 0.292, reflecting a 0.9% increase in explanatory power compared to the previous model.

A significant positive moderating effect of accounting conservatism was found ($\beta = 6.369$, $P < 0.05$). While dividend policies generally reduce the risk of financial distress, this effect becomes positive under accounting conservatism. High dividend payout ratios can deplete cash reserves needed for unexpected expenses, making financial strain more evident.

Conservative accounting encourages early reporting of potential losses or earnings declines, which can further limit liquidity and increase distress risk. Firms with high dividend payouts and conservative accounting may struggle to meet investor expectations, leading to negative market reactions, declining stock prices, and rising costs of capital, thus exacerbating financial distress.

Table 3: Panel Logistic Regression Analysis Results

Variables	Model 1	Model 2	Model 3	Model 4	Model 5
Constant	-57.919(1.61) **	-68.48(17.1) **	-51.284(15.2) **	-56.913 (17.5) **	-57.282 (17.82) **
Firm Age	32.711 (9.05) **	38.427 (10.4) **	30.712(9.2) **	34.011(10.61) *	33.98(10.76) **
Firm Size	-5.918 (14.7) **	-3.809(1.81) *	-4.549(2.4) *	-4.669(2.07) *	-4.559(2.20) *
Predictors					
Financial leverage		0.238(0.08) *	0.592(0.14) **	0.589(0.14) **	0.564(0.048) **
Investment Rate		2.199 (0.69) *	3.271(0.85) * *	3.666(0.92) **	3.789(0.92) **
Dividend payout ratio		-1.852(0.79) *	-1.259(0.71) *	-1.074(0.72) *	-0.788(0.65) **
Interactions					
Financial Leverage *Accounting conservatism			-2.84 (0.63) **	-3.02(0.65) * *	-2.905(0.64) * *
Investment rate * Accounting conservatism.				17.518(7.6) **	15.657(7.51) *
Dividend payout * Accounting conservatism.					6.369(3.62) *
Model summary statistics					
Wald chi2		18.59	30.55	43.96	41.77	44.22
Prob > chi2		0.000	0.000	0.000	0.000	0.000
Log-likelihood		-177.538	-159.471	-141.253	-137.49	-135.918
R Square		0.112	0.17	0.264	0.283	0.292
R2 Change		-	0.058	0.094	0.019	0.009
Obs per group		14	14	14	14	14
No_ of firms		45	45	45	45	45
Total Panel Observations		630	630	630	630	630

** Significant at 0.01 level * Significant at 0.05 level; Figures in parenthesis are Standard. Errors; Source: Research Data, (2024)

Hypotheses Testing

Table 4 presents the results of the hypotheses testing, showing that all null hypotheses were rejected. Financial leverage, investment rates, and dividend payout policies were found to have significant effects on the likelihood of financial distress among firms at the Nairobi Securities Exchange. Additionally, accounting conservatism significantly moderated these relationships, reducing distress for leveraged firms while amplifying perceived risks associated with investment rates and dividend policies. These decisions underscore the critical role of financial management and conservative accounting practices in mitigating financial distress.

Table 4: Summary of the Study Results

	Hypotheses	Beta	p-Value	Decision
$H0_1$	Financial leverage does not have a significant effect on the likelihood of financial distress among corporate entities trading at NSE.	0.238	p<0.05	Reject $H0_1$
$H0_2$	The investment rate does not have a significant effect on the likelihood of financial distress among corporate entities trading at NSE.	2.199	p<0.05	Reject $H0_2$
$H0_3$	The dividend payout ratio does not have a significant effect on the likelihood of financial distress among corporate entities trading at NSE.	-1.852	p<0.05	Reject $H0_3$
$H0_{3a}$	Accounting conservatism does not moderate the relationship between financial leverage and the likelihood of financial distress among corporate entities trading at NSE.	-2.905	p<0.05	Reject $H0_{3a}$
$H0_{3b}$	Accounting conservatism does not moderate the relationship between investment rate and the likelihood of financial distress among corporate entities trading at NSE.	15.657	p<0.05	Reject $H0_{3b}$
$H0_{3c}$	Accounting conservatism does not moderate the relationship between dividend policy decisions and the likelihood of financial distress among corporate entities trading at NSE.	6.369	p<0.05	Reject $H0_{3c}$

Conclusion

The study investigated the impact of financial decisions on the likelihood of financial distress and the moderating role of accounting conservatism, offering valuable insights into how firms can enhance stability and sustainability. The findings revealed that higher financial leverage significantly increases the risk of financial distress due to elevated fixed obligations and reduced financial flexibility, emphasizing the need for firms to maintain optimal leverage levels and explore alternative financing options. Similarly, a high investment rate was found to correlate with increased distress, as investments, while essential for growth, can strain liquidity if returns do not meet expectations. Companies should carefully evaluate investments to balance immediate and long-term needs while maintaining stable cash flows.

Dividend policies were also shown to influence financial distress likelihood, with high payouts potentially straining resources despite signaling financial health. A sustainable and consistent dividend policy, supported by regular financial monitoring, was recommended to mitigate risks. Accounting conservatism emerged as a crucial moderating factor, reducing distress likelihood for firms with high leverage by ensuring accurate reporting and proactive risk management. However, the study also noted that conservative practices might

amplify perceived distress risks by lowering reported profits and asset values, underscoring the importance of transparent reporting and stakeholder communication.

The research highlighted the broader implications for regulatory bodies, managers, and stakeholders, advocating for prudent financial practices and enhanced risk management. Regulatory guidelines encouraging balanced leverage and robust investment evaluation frameworks can help mitigate financial distress risks. Firms should adopt sustainable dividend policies, promote conservative accounting practices, and prioritize strategic financial planning, including stress testing and scenario analysis, to ensure long-term stability. Managers are urged to align financial decisions with shareholder interests, enhance earnings quality, and regularly monitor financial health.

The study supports agency theory by demonstrating how accounting conservatism reduces financial distress likelihood in leveraged firms, fostering alignment between managerial and shareholder interests. It also aligns with positive accounting theory by illustrating the influence of conservatism on investment and dividend decisions, thereby impacting stakeholder confidence and firm stability. Shareholders play a crucial role in supporting optimal leverage, advocating for conservative reporting, and actively engaging with management to align financial policies with long-term goals. These findings underscore the importance of prudent financial decision-making and transparency in achieving corporate sustainability and growth

Limitations of the Study and Recommendations for Future Research

The current study found that accounting conservatism positively moderates the relationship between investment rate and the likelihood of financial distress. The results suggest that while conservative accounting practices are generally expected to reduce risk, they might amplify the perceived risk when firms engage in high investment activities. This counterintuitive finding warrants further investigation.

Future studies should explore the underlying mechanisms driving this relationship. Researchers could employ different methodologies to understand the dynamics at play. Additionally, longitudinal studies that track firms over time could provide insights into how this relationship evolves under different economic conditions.

The study also found that accounting conservatism negatively moderates the relationship between financial leverage and financial distress, suggesting that conservative accounting practices can mitigate the risks associated with high leverage. However, the strength of this relationship may vary across different industries or economic environments, which the current study did not fully explore.

Future research should consider conducting industry-specific analyses to determine whether the observed moderation effect of accounting conservatism holds consistently across various sectors. Additionally, examining the impact of economic cycles (e.g., during recessions or booms) on this relationship could provide a more nuanced understanding of when and how accounting conservatism effectively mitigates the risks associated with financial leverage.

The study indicated that accounting conservatism positively moderates the relationship between dividend payout ratios and financial distress, suggesting that conservative practices might highlight the risks of high dividend payouts. However, the broader implications of this finding, especially about different types of dividend policies were not fully explored.

Further studies should investigate how different dividend policies interact with conservative accounting practices to influence financial distress. Comparative studies that differentiate between companies with stable dividend policies and those with more aggressive or irregular payout strategies could provide deeper insights. Moreover, exploring the impact of market perceptions and investor expectations on this relationship could offer valuable contributions to the literature on corporate finance and risk management.

The current study provides important insights, but its findings, particularly those that are counterintuitive or reveal complex interactions, require further validation. The potential limitations related to sample size, industry representation, and the economic context in which the data was collected may have influenced the results.

A confirmatory study, ideally with a larger and more diverse sample, is recommended to validate the findings of this research. Such a study should aim to replicate the current analysis while also addressing any potential biases or limitations identified in this study. By doing so, future researchers can confirm whether the observed relationships hold in different contexts or whether they are specific to the conditions of the original study.

Despite these limitations, the findings offer valuable implications for firms, regulators, and stakeholders, emphasizing the importance of prudent financial practices and conservative accounting. However, applying these results beyond the Kenyan context requires caution. Further validation through comparative studies in different economic environments and larger, more diverse datasets will be crucial to establish the broader applicability and robustness of these conclusions.

By addressing these limitations, future research can refine the theoretical and practical contributions of this study, ensuring a deeper and more accurate understanding of the intricate relationships between financial decisions, accounting conservatism, and financial distress.

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