Original Research Article

Impact of Debt Composition and Accounting Conservatism on Financial Distress in Emerging Markets

ABSTRACT

Aims: This study investigates the impact of debt composition, specifically short-term and long-term debt, on corporate financial distress, focusing on the moderating role of accounting conservatism. It aims to understand how firms in emerging markets, particularly Kenya, can achieve financial stability through prudent debt structuring and conservative accounting practices.
Study design: The research adopted an explanatory research design.
Place and Duration of Study: The study utilized financial data from firms listed on the Kenyan Securities Exchange between 2008 and 2021.
Methodology: The study analyzed a sample of 45 firms trading at the Nairobi Stock Exchange over 14 years from 2008 to 2021. The study used panel logistic regression, a statistical method for analyzing data with multiple observations over time, to test its hypotheses.
Results: The results show that both short-term and long-term debt increase the likelihood of financial distress, with accounting conservatism further intensifying the risk for firms heavily reliant on short-term debt while mitigating it for those with long-term debt. This suggests that conservative accounting practices, which promote early recognition of losses, may exacerbate financial distress for firms heavily reliant on short-term debt. In contrast, for long-term debt, accounting conservatism has a mitigating effect helping firms manage their debt obligations more effectively over time. This highlights a nuanced role of accounting conservatism, where it increases the pressure on firms with short-term debt while providing stability for those with long-term obligations.
Conclusion: The findings suggest that corporate managers in emerging markets should carefully balance short- and long-term debt to minimize financial distress risks. Additionally, adopting conservative accounting practices can serve as a safeguard, providing early warning signals for financial trouble and enhancing corporate stability. Managers should therefore carefully balance short-term and long-term debt to reduce financial distress while adopting conservative accounting practices to enhance financial transparency and risk management. Policymakers can support firms by promoting responsible debt management and offering incentives for conservative financial reporting to strengthen overall financial stability.

Keywords: Accounting Conservatism, Long-term Debt, Short-term Debt, Financial Distress

1. INTRODUCTION

Corporate financial distress is increasingly prevalent worldwide, as businesses face mounting challenges in fulfilling their financial obligations. Defaults on debt repayments,

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restructuring efforts, and shrinking asset bases have become common occurrences in both developed and emerging economies [1]. Research shows that capital structure decisions are the main reasons why companies face financial distress. In addition, research has also indicated that accounting conservatism acts as a protective mechanism for improving the financial sustainability of firms [2].Managing capital structure mix, particularly debt financehas become a central focus for firms seeking to maintain stability and avoid financial distress.

Empirical research reveals that debtcomposition which is typically classified into short-term and long-term debt. Short-term debt, which refers to obligations due within a year, often provides liquidity for immediate needs but can increase financial pressure if not managed prudently, [3]. On the other hand, long-term debt involves obligations due after more than a year, offering a longer horizon for repayment but posing risks if a firm's cash flow cannot sustain the repayment over the long term, [4]. The relative proportions of short- and long-term debt in a company's capital structure can significantly influence its financial stability.

While the relationship between debt composition and corporate financial stability has been studied in the context of both developed and emerging markets, moderating role of accounting conservatism on this relationship remain underexplored. Accounting conservatism, which encourages the early recognition of potential losses and liabilities, can help mitigate the risks associated with debt financing by ensuring that firms recognize financial distress at an earlier stage, allowing for proactive management,[5]. In emerging markets, where access to long-term financing is often limited, and short-term debt reliance is higher, accounting conservatism can be especially valuable in helping firms manage debt portfolios and maintain corporate stability.

This study seeks to examine the effects of debt compositionspecifically, short-term and long-term debt—on corporate financial stability, with a particular focus on the moderating role of accounting conservatism in this relationship. The research aims to provide insights into how debt structuring and accounting practices interact to influence corporate resilience, especially in the context of emerging markets such as Kenya.

Financial distress occurs when a company struggles to generate enough cash flow to meet its debt obligations. This inability to pay creditors, suppliers, and other stakeholders often signals a broader liquidity issue that can, if unaddressed, escalate into bankruptcy or insolvency [6, 7]. The reliance on debt as a primary source of financing is common for corporations, but the composition of this debtwhether it is short- or long-termplays a crucial role in determining the level of financial risk a Firm faces.

Short-term debt, while often necessary for maintaining liquidity, can become a source of financial strain if a firm is unable to roll over its debt or generate sufficient cash flow to meet repayment obligations. Firms with high levels of short-term debt may find themselves under constant pressure to secure new financing or boost revenues, leading to heightened vulnerability during periods of economic instability [3]. Furthermore, the inability to manage short-term debt effectively can result in liquidity crises, which may quickly spiral into broader financial distress.

In contrast, long-term debt provides a longer timeline for repayment and can offer more stability, particularly in volatile market environments. However, firms that take on excessive long-term debt without considering their future cash flow prospects may find themselves constrained by debt service obligations that limit their ability to invest in growth opportunities or respond to market changes [4]. The interest and principal repayments on long-term debt

can become a heavy burden if the firm's revenue streams do not keep pace with its debt obligations, potentially leading to financial distress over time.

Accounting conservatism is a financial reporting approach that prioritizes the recognition of potential losses and liabilities over gains. By encouraging firms to report expected losses earlier, conservatism reduces the risk of overstating financial health and provides a more realistic view of a firm's financial position [5]. In the context of debt financing, accounting conservatism can act as a safeguard by ensuring that firms recognize financial distress earlier and take corrective action before the situation worsens.

[8] suggest that accounting conservatism improves a firm's ability to manage cash flow and mitigate the risks associated with debt financing. By promoting early loss recognition, conservatism can help firms avoid excessive debt accumulation and reduce the likelihood of financial distress. This is particularly relevant for firms with high levels of short-term debt, where the risk of financial distress is elevated due to the need for constant liquidity management. Accounting conservatism can provide an additional layer of protection by encouraging firms to take a more cautious approach to debt financing, ensuring that potential risks are identified and addressed promptly[5].

In emerging markets, where access to capital is often more constrained, and firms may have fewer options for long-term financing, the role of accounting conservatism becomes even more critical[9]. Firms in these markets are often more reliant on short-term debt, which increases their exposure to financial distress. By adopting conservative accounting practices, firms can better manage the risks associated with short-term debt and improve their overall financial stability, [10].

Emerging markets such as Kenya face unique challenges in managing corporate debt. Access to long-term financing is often limited, forcing companies to rely more heavily on short-term debt to meet their liquidity needs [1]. This reliance on short-term debt can make firms more vulnerable to financial distress, particularly during periods of economic downturn or market volatility. As a result, firms in emerging markets must pay particular attention to the composition of their debt portfolios to ensure financial stability.

Research has shown that firms with high levels of short-term debt are more susceptible to financial difficulties, especially during periods of economic instability [1]. However, the specific impact of debt composition on corporate financial stability, particularly in the context of emerging markets, remains underexplored. This study seeks to fill that gap by analyzing how the balance between short-term and long-term debt influences financial distress among firms listed on the Kenyan Securities Exchange.

Moreover, the study will examine the moderating role of accounting conservatism in this relationship. By focusing on the interaction between debt composition and accounting practices, the research aims to provide a comprehensive understanding of how firms can structure their debt portfolios to enhance financial stability and reduce the risk of distress, particularly in volatile market conditions.

Specific objectives of the study

i. To determine the impact of long-term debts on the likelihood of financial distress
ii. To determine the effect of short-term debts on the likelihood of financial distress
iii. To determine the moderating role of accounting conservatism on the relationship between long-term debts and the likelihood of financial distress
iv. To determine the moderating role of accounting conservatism on the relationship between short-term debts and the likelihood of financial distress

Literature Review

Theoretical review

Agency Theory

Agency Theory, as explained by [11], highlights conflicts between principals (shareholders) and agents (managers) due to differing goals. Managers might prioritize their interests, such as excessive risk-taking or empire-building, which could negatively affect shareholders. Debt helps mitigate agency costs by limiting managers' control over free cash flow. Short-term debt, if poorly managed, increases financial distress risk, while long-term debt offers stability but may reduce managerial efficiency[12]. Accounting conservatism enhances transparency, helping curb opportunistic behavior by managers[13].

Positive Accounting Theory

Positive Accounting Theory (PAT), as outlined by[14], seeks to predict and explain firms' accounting choices based on stakeholder interests, particularly managers, creditors, and shareholders. It suggests that managers make accounting decisions to maximize their utility within the firm's constraints. PAT emphasizes that accounting conservatism helps reduce financial distress by promoting early recognition of losses and liabilities, curbing earnings management, and minimizing agency conflicts. This is especially crucial for firms with high debt, as it enhances transparency and aids in debt negotiations[15].

Trade-Off Theoryand Pecking Order Theory

The Trade-Off Theory [16] and Pecking Order Theory [18] address firms' capital structure decisions from different perspectives. The Trade-Off Theory suggests that firms balance the tax benefits of debt against the costs of financial distress, with short-term debt increasing distress risk and long-term debt providing stability but at higher costs. Accounting conservatism supports this balance by facilitating early recognition of economic issues, improving debt structuring, and reducing distress risk [17].

The Pecking Order Theory, on the other hand, posits that firms prioritize internal financing over debt and equity, preferring short-term debt due to its perceived lower cost. However, overreliance on short-term debt can lead to liquidity problems and financial distress. Accounting conservatism mitigates this risk by providing timely financial information, aiding firms in making informed financing decisions, and reducing distress probability [19].

Empirical Review and Hypotheses Development

The link between debt composition and financial distress has long been a critical area of research, with both short-term and long-term debt playing distinct roles in determining corporate financial stability[20]. The introduction of accounting conservatism into this discussion adds an important layer of financial prudence, emphasizing timely recognition of losses and risks[8]. Below is a review of the existing empirical studies and theoretical frameworks that support the development of hypotheses related to the impact of long-term and short-term debt on financial distress, and the moderating role of accounting conservatism.

Long-Term Debt and Financial Distress

Long-term debt, due to its extended repayment period, typically offers firms the flexibility to invest in capital-intensive projects without the immediate pressure of repayment[21]. However, if not properly managed, it can increase the overall debt burden and strain cash flows in the long run, especially if a firm's revenue streams are not sufficient to cover debt

servicing costs. According to [22], firms with high levels of long-term debt are more vulnerable to financial distress if they fail to generate adequate returns from their investments. This is particularly true in volatile market conditions, where income streams can become unpredictable.

On the other hand, some studies suggest that long-term debt may help firms avoid financial distress by providing a stable, predictable repayment structure [23, 24]. The static trade-off theory posits that firms with higher leverage, particularly long-term debt, may experience lower distress due to tax shields[25]. However, the relationship is not universally agreed upon, as certain studies have found mixed results depending on the industry and economic environment[26].

Based on the above discussion, the first hypothesis is:

***H1: Long-term debt has a significant effect on the likelihood of financial distress among corporate entities trading at NSE*.**

Short-Term Debt and Financial Distress

Short-term debt often entails higher risks due to its short maturity and frequent refinancing requirements. Firms with higher levels of short-term debt are more susceptible to liquidity crises, as they must continuously generate sufficient cash to repay these obligations. Several studies, such as [3]and[27], have shown that reliance on short-term debt can significantly increase the risk of financial distress, especially during economic downturns when refinancing becomes difficult or interest rates rise unexpectedly.

The pecking order theory suggests that firms prefer short-term debt to long-term debt because it is often easier to secure and involves lower transaction costs[28]. However, this short-term focus can backfire when cash flow becomes tight, forcing firms into distress[29]. Empirical studies in emerging markets, including Kenya, demonstrate that firms with higher proportions of short-term debt face elevated risks of financial instability due to their reliance on this form of finance [1].

Thus, the second hypothesis is formulated as:

H2: Short-term debt has a significant effect on the likelihood of financial distress among corporate entities trading at NSE.

Accounting Conservatism as a Moderator

Accounting conservatism, which emphasizes the timely recognition of liabilities and potential losses, is considered a protective mechanism against financial distress. By adopting conservative accounting practices, firms can recognize financial challenges earlier, allowing them to adjust their financial strategies, such as restructuring debt or conserving cash for debt repayment[8]. [30]found that accounting conservatism helps firms restructure earlier after covenant breaches, leading to better recovery rates in cases of default.

The moderating role of accounting conservatism can be particularly relevant for firms with high levels of long-term debt, as it encourages prudent management of long-term financial obligations. Firms that apply conservative accounting practices are more likely to recognize potential repayment difficulties and adjust their operations accordingly, thus reducing the likelihood of distress (Biddle et al., 2020).

Based on this reasoning, the third hypothesis is proposed:

H3: Accounting conservatism moderates the relationship between long-term debt and the likelihood of financial distress among corporate entities trading at NSE.

In the case of short-term debt, which poses immediate repayment obligations, accounting conservatism can play a crucial role in mitigating the risk of financial distress by promoting timely recognition of short-term liquidity problems. [31] found that firms with conservative accounting practices were better able to manage short-term debt, as they recognized financial risks early and made preemptive adjustments to avoid default.

Consequently, the fourth hypothesis is developed as:

H4: Accounting conservatism moderates the relationship between short-term debt

2. METHODOLOGY

Data Collection

Secondary data was collected from the annual financial reports of the 45 firms listed on the NSE during the study period. The data covers the period from 2008 to 2021. The firms included were chosen based on data availability and consistency across the years, ensuring the integrity of the panel dataset.

Measurement of Variable

Dependent Variable:

Financial Distress: Financial distress is measured using a modified version of Altman's Z-score [32]to evaluate the financial health of the sample firms. Research suggests that this model works well for both manufacturing and non-manufacturing firms, including those in emerging markets. Accordingly, a Z-Score of "1" was assigned to distressed firms and "0" to healthy ones.

Independent Variables:

Short-term Debt: This is measured as the ratio of short-term debt to total assets. Short-term debt refers to the liabilities due within one fiscal year and includes items such as short-term loans and trade payables [33].

Long-term Debt: Long-term debt is measured as the ratio of long-term debt to total assets. It includes financial obligations due after one fiscal year, such as long-term bonds and loans[34].

Moderating Variable:

Accounting Conservatism: Accounting conservatism is measured using the C-Score model developed by[35], which captures the tendency of a firm to recognize losses more quickly than gains. A higher score indicates a more conservative accounting approach.

Control Variables:

Firm Size: Measured as the natural logarithm of total assets, firm size accounts for scale effects on financial stability.

Firm Age: Measured as the natural logarithm of total assets, firm size accounts for scale effects on financial stability.

3. RESULTS AND DISCUSSION

Descriptive results

The descriptive statistics presented in Table 1 provide insights into the financial characteristics and stability of firms listed on the Nairobi Securities Exchange, based on a sample of 630 observations. The variables analyzed include financial distress (FD), long-term debt (LTD), short-term debt (STD), accounting conservatism (AC), firm age (FA), and firm size (FS).

The results show that the mean likelihood of financial distress (0.231) indicates that, on average, approximately 23.1% of the firms are experiencing some level of financial distress. This relatively low percentage suggests that while financial distress is present, a majority of firms may be managing their financial obligations adequately. The standard deviation (0.422) indicates substantial variability in distress levels among firms, implying that some firms face significant financial challenges, while others remain stable. The minimum value (0.000) shows that some firms do not experience any distress, whereas the maximum value (1.000) indicates that others are fully distressed. This wide range highlights the differing financial health across the sample.

Similarly, the results also indicate that the Mean long-term debt was (2.202) suggesting that, on average, firms have more than twice their equity financed through long-term debt. This could indicate a strategy of leveraging long-term borrowing for investment and growth. The high standard deviation (3.606) shows significant differences in long-term debt levels among firms. Some firms are heavily indebted, while others have minimal long-term obligations, as suggested by the negative minimum value (-8.926), which might reflect accounting losses or capital structure anomalies. The maximum value of 57.218 points to some firms having extremely high levels of long-term debt, potentially increasing their risk of financial distress if revenue does not cover repayment obligations.

Further, the results show that the Mean short-term debt (STD) was 0.316 suggesting a moderate reliance on short-term financing among the firms, indicating that many firms utilize short-term debt to manage immediate liquidity needs. A standard deviation of 0.274 reflects variability in short-term debt levels, indicating that while some firms manage this type of debt effectively, others may face greater risks associated with high short-term obligations. The minimum value of -0.856 indicates that some firms may have negative short-term debt (potentially reflecting excess cash or negative working capital), while the maximum value of 0.938 shows that certain firms are heavily reliant on short-term borrowing.

Table 1 also shows that the mean accounting conservatism score was (-0.843) implies a generally conservative approach to financial reporting among the firms. Negative values suggest that these firms are quick to recognize losses, which can help manage financial risk. The standard deviation (0.426) indicates some variability in accounting practices, with certain firms adopting more conservative approaches than others. The minimum value (-2.785) indicates a strong tendency toward conservatism in some firms, while the maximum value (-0.196) suggests that others are less conservative, potentially leading to varying financial reporting outcomes.

In addition, the average firm age was (3.976 years) which suggests that the sample consists of relatively young firms. This may imply a dynamic environment where firms are still in their growth or establishment phases. The standard deviation (0.543) reflects some diversity in firm ages, suggesting that while many firms are young, there are also older firms in the sample. With a minimum age of 1.386 years and a maximum of 4.836 years, the range

indicates that the sample includes both newly established firms and those with slightly more experience, which may influence their strategies and financial stability.

The average firm size was (7.029) indicating a moderate operational scale among the firms in the sample, which can influence their ability to manage debts and investments. A standard deviation of 1.132 suggests significant variability in firm sizes, indicating that the sample comprises both larger and smaller firms. The minimum size value of 3.818 and the maximum value of 9.201 suggest that the sample includes firms of varying operational scales, which can affect their financial decision-making processes and resilience against financial distress.

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
LTD	630	2.202	3.606	-8.926	57.218
STD	630	0.316	0.274	-0.856	0.938
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, **LTD:** Long term debt, **STD:** Short term debt, **AC:** Accounting conservatism, **FA:** Firm Age, **FS:** Firm Size, **P50:** 50th percentile, **Sd**: standard deviation, **Min**: minimum, **Max**: maximum, **N:**number of firms.*

Source: Research (2024)

Correlation Analysis

The correlation results for the variables related to financial distress (FD) provide insights into how firm age (FA), firm size (FS), long-term debt (LTD), short-term debt (STD), and accounting conservatism (AC) relate to the likelihood of financial distress among corporate entities trading at the Nairobi Securities Exchange (NSE). Below is an interpretation focusing solely on these variables' correlation with FD:

Table 2 shows that Firm Age has a positive and significant correlation with financial distress, (0.172, P< 0.05). This suggests that as firms age, they may face an increased likelihood of financial distress. While the correlation is relatively weak, it indicates that older firms may be more susceptible to financial challenges, potentially due to factors like increased operational complexities or outdated business models. These findings are consistent with [21]and[36], found that older firms often become entrenched in outdated practices, which can lead to inefficiencies and increased vulnerability to market fluctuations.

In addition, the results reveal that the correlation between firm size and financial distress is negative and significant (-0.271, P< 0.05). This indicates that larger firms are associated with a lower likelihood of financial distress. This negative relationship implies that larger firms may benefit from economies of scale, more diversified revenue streams, and better access to financing, which can enhance their financial stability. These findings are consistent with [37]and [21], who argued that larger firms typically have better access to capital markets and diversified operations, which can reduce their financial risk. Additionally, larger firms are often more resilient during economic downturns due to their established market positions and resource availability.

Further, the correlation between long-term debt and financial distress is positive and significant (0.348, P< 0.05). This suggests that higher levels of long-term debt are

associated with an increased likelihood of financial distress. This finding indicates that while long-term debt can be a tool for financing growth, excessive reliance on it can lead to financial strain if firms struggle to meet repayment obligations. These findings are consistent with agency theory, [38] and [39], which posits that high levels of debt can lead to conflicts between shareholders and creditors, ultimately increasing the risk of distress. Furthermore, demonstrated that firms with high long-term debt are more likely to face financial difficulties, particularly if they encounter revenue shortfalls.

Additionally, there is a strong positive correlation between short-term debt and financial distress, significant (0.707, P< 0.05). This high correlation indicates that firms with higher levels of short-term debt are considerably more likely to experience financial distress. This suggests that short-term debt can pose significant risks, particularly in terms of cash flow management, as firms may face liquidity challenges when obligations come due. This finding is consistent with [40], who noted that firms relying heavily on short-term financing often face liquidity issues that can lead to distress, especially during economic downturns. Additionally, [41]emphasized that firms with high short-term debt levels are more likely to encounter challenges in cash flow management, leading to increased financial instability.

Moreover, the correlation between accounting conservatism and financial distress is negative and significant (-0.102, P< 0.05). This implies that firms that practice accounting conservatism tend to have a lower likelihood of financial distress. By adopting conservative accounting practices, firms may be better positioned to manage risks and provide a more accurate reflection of their financial health, which can help in decision-making and financial planning. This finding is supported by[5], who argued that accounting conservatism helps firms recognize losses early, thus providing a more accurate representation of their financial health. Furthermore, [35] found that firms practising accounting conservatism are less likely to experience financial distress as they maintain a more prudent approach to financial reporting and risk management.

Table 2: Correlation results

	FD	FA	FS	LTD	STD	AC
FD	1.000					
FA	0.172*	1.000				
FS	-0.271*	-0.053	1.000			
LTD	0.348*	-0.053	0.299*	1.000		
STD	0.707*	-0.445	0.343*	0.290*	1.000	
AC	-0.102*	0.041	0.035	-0.086*	-0.056	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, **LTD:** Long term debt, **STD:** Short term debt, **AC:** Accounting conservatism, **FA:** Firm Age, **FS:** Firm Size, **P50:** 50th percentile, **Sd**: standard deviation, **Min**: minimum, **Max**: maximum, **N:**number of firms.*

Source: Research (2024)

Panel logistic regression results

Effects of Firm age and Firm size on the likelihood of financial distress

The analysis reveals that firm age has a positive and significant impact on the likelihood of financial distress (β = 32.711, P < 0.05). A one-unit increase in firm age raises the likelihood of distress by 32.711 units. This suggests that older firms may become more vulnerable to financial distress due to factors such as complacency, reduced innovation, and loss of competitive advantage. These results align with previous studies by[42],[21] and [43]who also found a positive relationship between firm age and financial distress.

In contrast, firm size shows a negative and significant impact on financial distress (β = -5.479, P < 0.05). This indicates that smaller firms are more likely to experience financial distress, with a unit change in firm size leading to a decrease of 5.479 units in distress likelihood. Larger firms, with their access to economies of scale, better resources, and diversification, are better equipped to avoid financial distress. These results are consistent with findings from[44], [45], [46], [47], [48], [49], and[50]. However, they contradict [51]and[52], who found a different relationship. The negative coefficient is explained by larger firms' ability to leverage operational efficiencies, strong market positions, financial flexibility, and greater access to capital, which reduce their likelihood of financial distress.

Effect of Long-Term Debt on financial distress

The results provided in Table 3 reveal a positive relationship between long-term debt and financial distress, with a coefficient of 0.238, P<0.05. This suggests that higher levels of long-term debt are associated with an increased likelihood of financial distress. A positive coefficient indicates that higher long-term debt is associated with increased log odds of financial distress. This implies that a unit increase in long-term debt increases the log odds of the likelihood of financial distress by 0.238 units. Financially healthy firms tend to rely more on equity than debt, as increasing long-term debt raises the likelihood of financial distress due to investors' perceptions of firms with high debt levels. Scholars argue that long-term debt reduces financial flexibility and therefore exposes firms to a higher risk of financial distress (the reduced-flexibility hypothesis). Additionally, elevated debt levels can result in higher interest expenses, which reduce profitability and exacerbate financial distress[53][54].

A company with a high debt-to-total assets ratio may need to allocate a significant portion of its profits to debt repayment, either by retaining earnings or being obligated to distribute profits according to debt agreements[54]. Firms with high debt levels often face restrictions on their financial flexibility, making it difficult to adapt during economic downturns or cash flow shortages, further increasing their risk of financial distress. Higher long-term debt leads to elevated interest payments, which can strain cash flows. If revenues are insufficient to cover these expenses, the firm may encounter financial distress. Moreover, firms with substantial debt may be subject to restrictive covenants imposed by lenders, limiting their operational flexibility and financial strategies. Failing to meet these conditions heightens the risk of distress.

High long-term debt also magnifies the effects of market fluctuations on profitability. Negative changes in market conditions can disproportionately affect firms with significant debt, making them more vulnerable to financial distress. Additionally, high levels of long-term debt signal greater risk to investors and creditors, potentially resulting in higher borrowing costs or reduced investment, which further exacerbates the risk of distress[38]. Firms with substantial debt may also experience downgrades in their credit ratings, leading to higher interest rates on new loans and difficulty securing financing, thus contributing to financial distress[39].

These findings align with previous research, including studies by[55], [21], [56], [57]found that long-term debt has a significant positive relationship with the likelihood of financial distress. However, the results contradict studies by[58], [59], and [26], found that long-term debt does not significantly increase the likelihood of financial distress. Similarly, these

findings are inconsistent with research by [60] and[61], who found no significant influence of long-term debt on financial distress.

Effect of Short-Term Debt on financial distress

Table 3 also shows that Short-term debt significantly impacts the likelihood of financial distress, as indicated by a positive coefficient of 7.199 ($p < 0.05$). This suggests that as short-term debt increases, the log odds of financial distress rise substantially. A unit increase in short-term debt leads to an increase of 7.199 units in the likelihood of financial distress, meaning that firms with higher levels of short-term debt are more likely to experience financial instability.

The reliance on short-term debt can increase a firm's vulnerability to financial distress because these debts need to be repaid or refinanced within a shorter timeframe, often during periods of tight liquidity. Scholars argue that short-term debt introduces significant financial pressure, as firms may struggle to meet their repayment obligations, especially if cash flow is insufficient. Additionally, high short-term debt levels can result in higher borrowing costs and increased exposure to interest rate fluctuations, which can further strain the firm's financial health [62, 63].

Firms with substantial short-term debt may also face challenges in securing refinancing during economic downturns or when credit markets tighten, exacerbating the risk of financial distress. Short-term debt can amplify the risk of liquidity crises, as firms may lack the necessary cash reserves to meet their obligations[2]. This aligns with the pecking order theory, which suggests that firms prioritize internal financing before seeking external funds, and short-term debt is often a last resort when other sources of capital are unavailable. As a result, high short-term debt levels signal financial weakness, increasing the likelihood of distress[28].

These findings are consistent with several studies that have identified a positive and significant relationship between short-term debt and financial distress, such as [55][56], [21], [57], [64], and[65]. However, the findings contradict research by [59] and [61], which found that short-term debt does not significantly affect financial distress. The discrepancy may arise from differences in the industry or market conditions studied, as well as the ability of some firms to efficiently manage short-term debt without increasing distress risks.

Furthermore, studies by [54] and [53] suggest that firms with high short-term debt levels are at greater risk of financial distress, particularly due to increased sensitivity to liquidity shortages and interest rate risks. Thus, firms that rely heavily on short-term debt may face significant challenges in maintaining financial stability, as reflected in the positive and significant coefficient found in this analysis.

Moderation results

Moderation Effect of Accounting Conservatism on the relationship between Long-Term Debt and financial distress

The results in Table 3 also reveal a significant and negative moderating effect of accounting conservatism on the link between financial leverage and financial distress ($\beta = -2.840$, $P < 0.05$). Since the beta coefficient is not zero and the model is significant with a notable R-Square change, it confirms that accounting conservatism plays a significant role in moderating this relationship. The findings suggest that although financial leverage generally increases the likelihood of financial distress, this effect is reversed when accounting conservatism is factored in. This implies that firms practising higher levels of conservatism are less likely to experience financial distress due to high leverage than those firms with high financial leverage but practice low levels of accounting conservatism. This is because

accounting conservatism leads to conservative financial reporting, which provides a more favourable picture of the company's financial stability, even in the presence of significant financial leverage.

This is because conservatism ensures that any potential difficulties in meeting debt obligations are reflected in the financial statements before they become critical[66]. By recognizing losses or setting aside provisions early, conservatism helps firms manage their financial risks more effectively. This proactive approach can reduce the likelihood of financial distress, even when a firm is highly leveraged. In addition, Creditors and other stakeholders often view conservative financial reporting as a sign of prudent management. When a highly leveraged firm practices accounting conservatism, it signals to creditors that the firm is aware of its financial risks and is taking steps to mitigate them [67]. This increased confidence can lead to more favourable financing terms, such as lower interest rates or more flexible repayment schedules, which can reduce the financial pressure on the firm and decrease the likelihood of financial distress. Firms that practice conditional conservatism are likely to take corrective actions sooner, such as restructuring their debt or adjusting their capital structure, in response to early signs of financial trouble. This proactive approach can prevent financial distress by addressing potential problems before they escalate [68].

By recognizing the risks associated with high leverage early and making necessary adjustments, conservatism helps firms maintain financial stability [69]. Firms that apply conservative accounting principles are likely to implement stricter risk management practices. By recognizing potential losses earlier and more cautiously, these firms are better equipped to handle financial difficulties, reducing the negative impact of high financial leverage. Conservative accounting helps stabilize earnings by avoiding overly aggressive revenue recognition and asset valuations. This reduced earnings volatility makes it easier for firms to manage their debt obligations, thus lowering the risk of financial distress Additionally, conservative accounting often leads to lower book values for assets and higher recognition of potential losses. This approach creates a financial cushion against shocks, making firms more resilient to the pressures of high leverage.

By practicing conservative accounting, firms can enhance investor confidence in their financial reports. Increased confidence can result in more stable stock prices and better access to capital, even with high leverage. Furthermore, conservative accounting improves debt management by offering a more accurate view of a firm's financial position, which can help in negotiating better terms with creditors and mitigating the effects of high leverage on financial distress. Finally, conservative accounting can help prevent excessive debt accumulation by highlighting potential risks and losses, thus reducing the likelihood of overleveraging and its associated financial distress. Firms that practice accounting conservatism may also be more conservative in their investment decisions. By avoiding overly aggressive or risky investments, these firms can reduce the likelihood of financial distress even when leveraging their capital.

Moderation Effect of Accounting Conservatism on the relationship between Short-Term Debt and financial distress

The moderation effect of accounting conservatism on the relationship between short-term debt and financial distress is both positive and significant, with a coefficient of 17.518 ($p < 0.05$). This result indicates that accounting conservatism amplifies the impact of short-term debt on the likelihood of financial distress. Specifically, as firms increase their use of short-term debt, the presence of a conservative accounting approach leads to a significantly higher increase in the likelihood of financial distress.

Accounting conservatism, which typically involves recognizing potential losses earlier than gains, can heighten the negative impact of short-term debt by limiting financial flexibility. Conservative accounting practices may make a firm's financial position appear weaker, increasing the perception of risk among creditors and investors. As a result, firms with higher short-term debt levels and conservative accounting may find it more difficult to secure favourable financing or manage liquidity risks, further exacerbating financial distress.

The coefficient of 17.518 suggests that for firms with higher short-term debt, adopting conservative accounting practices significantly magnifies the log odds of financial distress. This finding aligns with the view that accounting conservatism, while beneficial for prudent financial reporting, can act as a double-edged sword. It may protect creditors by highlighting potential risks earlier, but it can also increase the pressure on firms that rely on short-term debt by accelerating the recognition of potential financial difficulties. As a result, firms may face higher interest rates, tighter borrowing conditions, or challenges in refinancing, all of which contribute to financial distress.

This moderation effect is supported by prior research, including studies [5], [70], and[66], suggest that accounting conservatism enhances the transparency of financial reporting, often revealing financial strains earlier. Similarly, [71]and [72]found that accounting conservatism can expose firms to higher risks of financial distress by limiting the recognition of profits and emphasizing financial weaknesses.

In contrast,[73] and [73]highlight the protective role of conservatism in reducing agency costs and safeguarding creditors, but even these studies acknowledge the potential downside when firms face liquidity constraints from short-term debt. Additionally, [74]argue that conservatism can make it more challenging for highly leveraged firms to manage short-term financial obligations, especially during periods of financial stress.

Practical Implications for Managers and Policymakers

Managers of older firms should prioritize innovation and continuous improvement to counteract the increased likelihood of financial distress due to complacency or competitive loss, while smaller firms should scale up operations and improve efficiencies to mitigate distress risks. Policymakers can support these efforts by encouraging modernization programs and offering incentives for firm growth, improved access to capital, and better financial management. In managing debt, managers should carefully balance long-term and short-term debt, focusing on debt restructuring, maintaining a balanced capital structure, and developing strong cash flow management to minimize financial distress. Accounting conservatism can aid firms with high leverage by ensuring early recognition of financial difficulties, which promotes prudent debt management and signals financial stability to creditors and investors. However, managers should avoid overly conservative practices that may amplify the negative effects of short-term debt. Policymakers can assist by establishing guidelines that balance conservatism with financial flexibility, providing financial advisory services, and fostering access to affordable long-term financing. By promoting proactive risk management and ensuring accessible credit markets, particularly for firms practicing conservative financial reporting, policymakers can help firms manage financial risks effectively, thereby reducing the likelihood of financial distress and contributing to overall economic stability.

Table 3: Panel Logistic Regression Analysis Results

Variables	Model 1	Model 2	Model 3	Model 4

Constant	-57.919(1.61) **	-68.48(17.1) **	-51.284(15.2) **	-56.913 (17.5) **
Firm Age	32.711 (9.05) **	38.427 (10.4) **	30.712(9.2) **	34.011(10.61) *
Firm Size	-5.918 (14.7) **	-3.809(1.81) *	-4.549(2.4) *	-4.669(2.07) *
Predictors				
Long-term debt		0.238(0.08) *	0.592(0.14) **	0.589(0.14) **
Short-term debt		7.199 (0.69) *	8.271(0.85) * *	8.666(0.92) **
Interactions				
Long-Term Debt *Accounting conservatism			-2.84 (0.63) **	-3.02(0.65) * *
Short-Term Debt * Accounting conservatism.				17.518(7.6) **
Model summary statistics				
Wald chi2	18.59	30.55	43.96	41.77
Prob > chi2	0.000	0.000	0.000	0.000
Log-likelihood	-177.538	-159.471	-141.253	-137.49
R Square	0.112	0.17	0.264	0.283
R2 Change	-	0.058	0.094	0.019
Obs per group	14	14	14	14
No_ of firms	45	45	45	45
Total Panel Observations	630	630	630	630

** Significant at 0.01 level * Significant at 0.05 level; Figures in parenthesis are

4. CONCLUSION

Summary of Key Findings

The study highlights several key relationships between firm characteristics, debt structures, accounting conservatism, and financial distress. First, firm age positively correlates with financial distress, suggesting older firms are more susceptible due to factors such as complacency or reduced competitiveness, while larger firms exhibit a negative relationship with distress, benefiting from economies of scale, diversification, and financial flexibility. The findings also reveal that both long-term and short-term debt increase the likelihood of financial distress, though long-term debt does so at a slower rate compared to short-term debt, which poses immediate liquidity challenges. Accounting conservatism is shown to moderate the debt-distress relationship, mitigating the negative effects of long-term debt by improving financial transparency and risk management, but potentially amplifying distress in firms reliant on short-term debt by reducing financial flexibility. These results underscore the importance of appropriate debt structuring and the role of conservative accounting practices in managing financial health.

Limitations of the study and future research

Several limitations were identified in the current study. First, the study does not account for industry-specific factors, such as market volatility or capital intensity, which could affect the relationship between debt and financial distress. Future research should address this by exploring how sector-specific characteristics influence debt management and distress risk. Second, the study primarily focuses on long-term and short-term debt without considering alternative financial strategies, such as debt restructuring, equity financing, or hybrid securities, that could mitigate distress. Future studies could examine how these strategies

interact with various forms of debt and provide firms with more effective ways to manage financial risks. Third, the study's cross-sectional approach limits the understanding of how the moderating role of accounting conservatism may evolve. Longitudinal studies could assess how the impact of conservatism shifts with changing market conditions or as firms mature. Lastly, cross-country comparative research would be valuable in exploring how different national financial systems, regulatory frameworks, and cultural factors influence the debt-conservatism-distress relationship, particularly between developed and emerging markets.

Disclaimer (Artificial intelligence)

Author(s) hereby declare that NO generative AI technologies such as Large Language Models (ChatGPT, COPILOT, etc.) and text-to-image generators have been used during the writing or editing of this manuscript.

COMPETING INTERESTS

Authors have declared that they have no known competing financial interests OR non-financial interests OR personal relationships that could have appeared to influence the work reported in this paper.

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APPENDIX

Model specification

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

logit(p)it = β0 +β1$SIZEit$ +β2$AGEit$ +β3LTDit +β4STDit+ϵ.....Model 2

logit(p)it = β0 +β1$SIZEit$ +β2$AGEit$ +β3LTDit +β4STDit+β5LTDit∗Mit+ϵ……Model 3

logit(p)it= β0 +β1$SIZEit$ +β2$AGEit$ +β3LTDit +β4STDit+β5LTDit∗Mit +β7STDit∗Mit
+ϵ……..……Model 4

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

β1…β11 = regression coefficients

$SIZE$ = Firm size

AGE= Firm age

LTD = Long-term Debt

STD= Short-term Debt

M = Accounting conservatism which is the moderator

ϵ = Error term

i = Company

t =Year