

# Profitability, Liquidity, and Firm Value: Does Financial Distress Have A Mediating Effect? (Study of Manufacturing Companies in Indonesia)

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# Profitability, Liquidity, and Firm Value: Does Financial Distress Have A Mediating Effect? (Study of Manufacturing Companies in Indonesia)

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## ABSTRACT

Good company conditions will attract investors to invest, profitability and liquidity are important things in investor assessment. The higher profitability and liquidity value will reduce the possibility of a company to be in financial distress. This research aims to examine the mediating effect of Financial Distress in the relationship between Profitability and Liquidity to Firm Value. The study was conducted on 170 manufacturing companies listed on the IDX for the year 2016-2020. The data were analyzed using Partial Least Square (PLS) statistical analysis. The results show that there is perfect mediation in the relationship between Profitability and Firm Value through financial distress, as well as Liquidity as the independent variable. The main finding of this study is that Profitability and Liquidity have no direct effect on Firm Value, but have an indirect effect through Financial Distress. In accordance with signal theory, information related to financial situations that are free from Financial Distress can provide a positive signal for investors to invest so that Firm Value will increase. This research contributes to the firm who wants to maximize their Firm Value, also to the literature that are related to the mediating role of Financial Distress in predicting the effect of Profitability and Liquidity on increasing Firm Value.

**Key words:** Financial Distress, Financial Performance, Firm Value, Liquidity, Profitability.

## 1. INTRODUCTION

The number of start-up companies that have emerged show that development and competition in the business world are getting tougher, thus requiring companies to continue to compete in maintaining a stable and increasing value. Company value is one of the important aspects that must be built by the company because the value of the company represents the success level of the company.

To assess the company can be done by looking at the financial performance. Financial performance as a description of the company's financial condition, aims to determine the condition of the company which is described through financial ratios. Profitability and liquidity ratios are used in this study because the profitability ratios can show the company's ability to generate profits and as a tool to measure the company's operational and financial activities [1]. Liquidity can be used to assess the company's ability to pay short-term debt [2]. The higher the liquidity value, the more liquid the company is, which is a good sign for investors to invest.

Research [3], [4] show that Profitability has no effect on Firm Value. In contrast, [5] found a significant positive effect

between Profitability and Firm Value because when the company earns high profits, the stock price will increase so that the Firm Value also increases. [6] found that Liquidity and Firm Value had a significant positive relationship, but [7] found a negative and not significant relationship between Liquidity and Firm Value.

Profitability and Liquidity can also predict the company's financial condition and whether the company is experiencing distress or not. Financial distress is a condition where the company is in a declining financial stage and could result in bankruptcy [8]. Companies that have poor performance indicate that the profits generated are not sufficient to meet their obligations, so the lower Profitability and Liquidity, the higher potential that company will experience Financial Distress.

Because of the inconsistent results, purpose of this study is to further examine the relationship between Profitability, Liquidity and Firm Value by adding Financial Distress as a mediating variable because it is an illustration of the company's financial condition, which is an effective method for investors to see the company's condition.

Manufacturing companies were chosen to be the research sample because they are one of the sectors that have many sub-sectors of companies and have sustainable production, so that they have more assets than other sectors in accordance with the Profitability and Liquidity variables that use assets as the basis for calculations.

## 2. THEORETICAL FRAMEWORK & HYPOTHESIS DEVELOPMENT

### 2.1 Theoretical Framework

#### 2.1.1 Agency Theory

Agency theory is a theory where the principal and agent have different interests so that there is a conflict of interest and information asymmetry where the information obtained by management is more than the principal because management has direct involvement in the company [9].

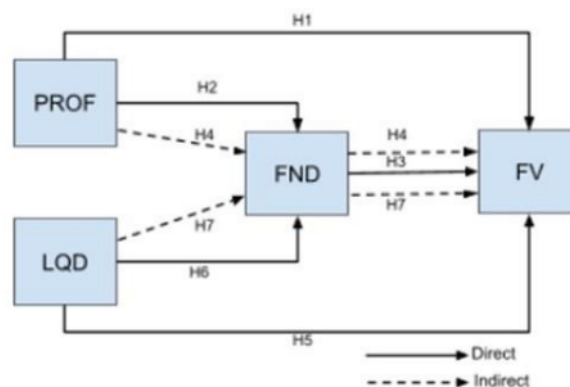
The relationship between agency theory and all variables is that management has responsibilities to external parties in the form of financial performance disclosures such as Profitability and Liquidity which are contained in financial statements as consideration in making decisions. However, the information presented is not always available and can be hidden, resulting in losses for the principal [10].

#### 2.1.2 Signaling Theory

Signal theory provides information to investors and external parties about a company which will later become a signal for investors to make a decision. This theory also shows how management takes action and provides direction to investors on assessing company [2]. By producing quality financial reports, the information needed by investors will be fulfilled [11], thereby reducing information asymmetry between agents and principals.

The relationship between signal theory and all variables is the availability of good information, helping investors assess the company's ability to generate profits and fulfill its obligations, so that it will provide signals for investors to make decisions. Higher profitability and liquidity indicate that the possibility of the company experiencing Financial Distress is getting smaller, this is a positive signal for investors so that it can improve the company's reputation, price and number of shares which will certainly increase the Firm Value.

### 2.2 Relationship Between Variables



**Figure 1.** Research Model

There are 4 variables in this study, which is Profitability symbolized by PROF and Liquidity symbolized by LQD as the independent variable, Firm value symbolized by FV as the dependent variable, and Financial Distress symbolized by FND as the intervening variable.

Profitability is a ratio to see the effectiveness of management related to investment and sales or income [12]. Profitability can show the company's ability to generate profits and the company's ability to manage its assets effectively and efficiently.

Liquidity is a ratio that measures the company's ability to pay short-term obligations [13]. Liquidity is generated by current assets and current liabilities such as cash, receivables, inventories, as well as short-term debt, bonds, etc.

Financial distress is a company's financial condition where the company has difficulty paying its obligations because it is incapable of generating sufficient profits.

Firm Value is an investor's measure or perception of the company's success [14]. The company's goal within increasing Firm Value is to gain satisfaction and prosperity for the company and shareholders [15].

#### 2.2.1 PROF and FV

PROF has an important role in companies that come a benchmark for investors in assessing the company and the company's prospects in the future, so that if the PROF value increases, it will also increase FV. In accordance with signal theory, information related to the company's PROF value will be a positive or negative signal for investors in making investment decisions. The increase in PROF will also minimize agency costs that arise due to information asymmetry in agency theory.

[16] suggested that PROF has a significant positive relationship to FV because PROF can show the level of profit generated by the company which will later be distributed to

shareholders in the form of returns and dividends, so it can be said that higher PROF will cause an increase in FV which is reflected by rising stock prices. These results are in line with [17] which found that PROF has a positive and significant relationship to FV, because investors in making decisions will look at the company's PROF value to assess whether the assets owned can be used effectively and the profits earned have been maximum or not. So that the hypothesis can be determined as follows:

H1: PROF has a positive effect on FV.

## 2.2.2 PROF and FND

Based on agency theory, PROF can play a role in reducing conflict because it provides information for external parties who can find out the condition of the company [9]. By knowing the condition of the company, we can find out how much profit is generated and how effective is the management of company assets. The higher PROF value, the better asset management in generating profits, so the risk of FND is lower. Because the high profit generated indicates that the company has sufficient funds to meet and pay its obligations. On the other hand, the lower PROF means the higher probability of FND because the company does not have sufficient funds to pay its obligations.

[18] found that PROF had a negative effect on FND. This study is in line with [19] which found that PROF has a significant negative effect on FND because PROF as measured by ROA can show how the company's financial condition is. So that the hypothesis can be determined as follows:

H2: PROF has a negative effect on FND.

## 2.2.3 FND and FV

The high FND value indicates that the company is experiencing financial difficulties so that it cannot pay its obligations. This is a concern for investors to assess whether the target company is healthy or not. Investors will certainly ensure that the target company is free from financial problems and has reliable financial and non-financial activities.

Thus, if the company's FND is higher, the FV will be lower because investors will not invest in high-risk companies that also cannot fulfill their obligations. So that the hypothesis can be determined as follows:

H3: FND has a negative effect on FV.

## 2.2.4 PROF, FND and FV

Based on signal theory, PROF is information that must be provided by the company. A high PROF will improve the quality of financial reports which have an impact on increasing

profits and the company's stock price. This is a positive signal for investors to the company in investing activity. Information about the financial condition is related to the PROF value so that, by knowing the PROF value, we can have an idea of whether the company is experiencing FND or not. FND information will be useful for investors so that investors do not only look at the profit side, but also from the company's financial condition. So that the hypothesis can be determined as follows:

H4: FND mediates the relationship between PROF and FV.

## 2.2.5 LQD and FV

Liquidity, which is also a financial ratio, has a role in the company's success [20]. LQD can provide information on the company's ability to pay its current obligations. The higher LQD, the higher FV will be, because it reflects that the company is in a good condition [16]. In accordance with the signal theory, that company information can provide a signal to investors. Companies that are liquid, show that the company is able to pay its short-term debt so that it will be a positive signal for investors. It can be concluded that the high value of LQD will cause FV to increase.

[6], [21] found that LQD has a significant positive relationship with FV because the value of LQD provides information regarding the availability of funds to pay all current liabilities which cause investor's perceptions of good companies and FV will increase. So that the hypothesis can be determined as follows:

H5: Liquidity has a positive effect on FV.

## 2.2.6 LQD and FND

LQD symbolizes the company's ability to meet its short-term obligations. LQD can reduce conflicts that occur according to agency theory. The availability of information for all parties will reduce the occurrence of information asymmetry between the agent and the principal. The availability of information regarding LQD allows the market to see how the company's ability to meet its current obligations is.

[22] revealed that the company is in a liquid state if the company has more current assets than its current liabilities. A high LQD indicates that the company's financial condition is strong [8], and the company can avoid the possibility of FND in the current period. This statement is in line with the results of [23] which found that LQD has a negative effect on FND because a high LQD value indicates that the company is able to pay off its current obligations, the possibility of the company experiencing FND will be smaller. So that the hypothesis can be determined as follows:

H6: LQD has a negative effect on FND.



### 2.2.7 LQD, FND and FV

FND is a benchmark for investors in making investment decisions because it can reflect the company's financial condition. A small FND indicates that the company is not in a difficult financial condition, thus attracting investor interest and confidence in the company with the assumption that the company will be going concern, also able to provide high returns and dividends as well. The increasing number of investors in the company will cause the number and price of shares to increase as well as the value of the company itself.

The results of research [24] found that LQD had a negative effect on FND. This means that the higher LQD ratio, the lower chance of a company experiencing FND. So that the hypothesis can be determined as follows:

H7: FND mediates the relationship between Liquidity and FV.

## 3. RESEARCH METHODS

### 3.1 Data Selection and Collection

The type of data used in this study is quantitative data using secondary data in the form of company financial statements obtained from the Bloomberg and IDX websites.

### 3.2 Population and Sample

170 manufacturing companies listed on the IDX for 2016-2020 was taken as the research sample, using a purposive sampling technique based on the following criteria: 1). Manufacturing companies that are listed on the IDX and are not delisted during 2016-2020, 2). The company uses Rupiah as the currency in the presentation of financial statements, 3). The company experienced and reported profits during 2016-2020, 4). The company issued financial statements for 2016-2020 which ended on December 31, 5). The company has a Z-Score < 6, and 6). The company has a complete and reliable data.

### 3.3 Measurement and Operational Definition of Variables

#### 3.3.1 Firm Value

FV was measured using the Tobin's Q formula to find out the company's performance through the company's growth and development opportunities in investment activities as well as market assessment of the company's prospects. FV is generated from the calculation of a company's market value of equity and book value of debt, divided by the company's total assets. Formulated as follows:

$$FV = [(P \times Q) + \text{Debt}] / \text{Total Assets}$$

Information:

FV = Firm Value

P = Closed price

Q = Number of shares outstanding

Debt = Book value of Total Debt

TA = Total Assets

### 3.3.2 Financial Distress

FND in this study was measured using the Altman Z-Score to calculate the financial difficulties or economic failure experienced by the company, as well as predict the risk of company bankruptcy [25]. Using a special method to calculate manufacturing companies that formulated as follows:

$$FND = (1.2 \times X1) + (1.4 \times X2) + (3.3 \times X3) + (0.6 \times X4) + (0.99 \times X5)$$

Information:

FND = Total Index

X1= Working Capital/Total Assets

X2= Retained Earnings/Total Assets

X3= Earnings Before Interest and Taxes/Total Assets

X4= Market Value of Equity/Total Liability

X5= Sales/Total Assets

### 3.3.3 Profitability

PROF in this study was measured using the Return on Asset (ROA) formula to determine a company's ability to utilize its assets to generate profits and the rate of return from asset investment activities, especially in fixed assets. PROF is formulated with the following formula:

$$\text{PROF} = \text{Net Income} / \text{Total Assets}$$

### 3.3.4 Liquidity

LQD in this study is measured by the Current Ratio formula to determine the company's ability to pay its short-term debt. Current Ratio uses current assets or liabilities in its calculation by looking at the number of current assets owned by the company to pay its short-term debt. Current Ratio can be formulated with the following formula:

$$LQD = \text{Current Asset} / \text{Current Liabilities}$$

### 3.4 Data Analysis Method

To find out the relationship between Profitability and FV through FND, this study used PLS (Partial Least Square) as data analysis method with the help of SmartPLS application. This method was chosen to see the mediating effect produced by FND through observations on the value of the indirect effect.

## 4. RESULTS AND DISCUSSION

### 4.1 Descriptive Statistics

Variable	N	Min	Max	Mean	Std. Deviation
PROF	170	0.000	0.140	0.044	0.029
FND	170	0.970	5840	2,790	1,110
FV	170	0.240	3.110	0.916	0.518
LQD	170	0.860	6.020	1,894	0.912
Valid N	170				

**Table 1.** Descriptive Statistics

It can be seen that the companies used in this study were 170 samples (N). The minimum value of PROF is 0.00 and the maximum value is 0.140. The average of PROF shows the lowest result compared to the average value of other indicators, which is 0.044, which means that the company's average rate of return in managing its assets is only 4.4%. It can be said that manufacturing companies are less effective in managing their assets because they have the lowest average value which is only 4.4%.

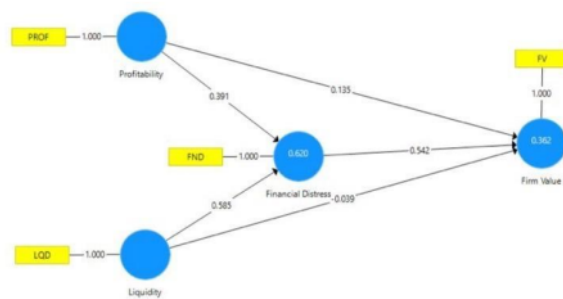
FND has a minimum value of 0.970 and a maximum value of 5,840. The average of FND shows the highest value compared to other indicators, which is 2.79, which means the company is in the gray zone because it has a value < 2.99. Even though the companies are not in a distress zone, there is a possibility that the gray zone will move into a distress zone. So, appropriate action is needed for companies to be able to move positions into a safe zone which has a z-score  $\geq 3$ .

The minimum LQD value is 0.86 and the maximum value is 6.020. While the average value of LQD is 1,894 which is quite high that reflects the good condition of the company. This proves that the average manufacturing company has a good level of liquidity.

FV has a minimum value of 0.240 and a maximum value of 3.110. While the average value of FV is 0.916, which means that the average manufacturing industry company has the ability to utilize its assets to earn profits up to almost 1x of the total assets it has, which is 0.9 times.

#### 4.2 Outer Model Analysis

This is used to see the relationship of each indicator towards research variables by testing the validity and reliability of the data used. Outer Model test results are as follows:



**Figure 2.** Outer Model

##### 4.2.1 Reliability and Validity Test

Reliability and Validity test is conducted to see whether the data used in a study is valid and reliable and to anticipate the possibility of data anomalies.

##### Construct Reliability and Validity

Variable	Cronbach's Alpha	rho_A	Composite Reliability	AVE
Liquidity	1.000	1.000	1.000	1.000
Financial Distress	1.000	1.000	1.000	1.000
Firm Value	1.000	1.000	1.000	1.000
Profitability	1.000	1.000	1.000	1.000

**Table 2.** Construct Reliability and Validity

In the reliability and validity test, there are several tests and the minimum value of each is expected. Cronbach's Alpha is expected to have a value  $>0.6$ , Composite Reliability is expected to have a value  $>0.8$  and AVE is expected to have a value  $>0.5$ . The AVE value  $<0.5$  is considered inadequate because it's unable to explain at least 50% of the variance of each indicator so that the variable can be considered invalid. Based on the table above, it can be seen that all the variables used in this study have results exceeding the minimum value of each test and prove that all variables are reliable.

##### 4.2.2 Discriminant Validity Test

Indicator	Liquidity	Financial Distress	Firm Value	Profitability
LQD	1,000	0.589	0.692	0.550
FND	0.589	1,000	0.371	0.422
FV	0.692	0.372	1,000	0.272
PROF	0.550	0.422	0.272	1,000

**Table 3.** Cross Loading

It can be seen that the loadings value and the correlation between indicators and its variables are greater than the correlation values between different indicators and variables.

Thus, it can be concluded that the tested data is a valid data because it has a greater loading value for each variable and indicator than the loading value between different indicators and variables.

### 4.3 Inner Model Analysis

After analyzing the Outer Model, the observations of the research results are based on the inner model as follows:

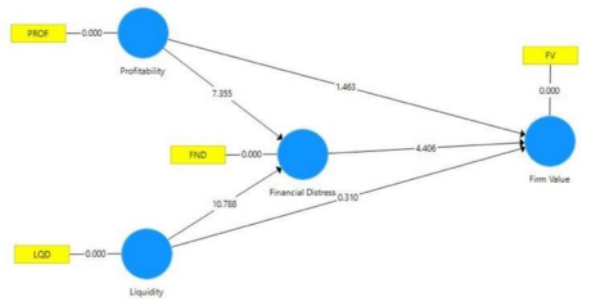


Figure 3. Inner Model

#### 4.3.1 R-Square

The R-Square test was conducted to test and see the ability of the dependent variable that could be explained by the independent variable. The resulting value ranges from 0-1, where a higher value or closer to 1 is a better result. The following are the results of the R-Square test described in the table as follows:

Variable	R-Square	R-Square Adjusted
Financial Distress	0.620	0.615
Firm Value	0.362	0.350

Table 4. R-Square

It is known that FND has a value of 0.620, which means that FND is influenced by the independent variables PROF and LQD, and the value of dependent variable FV is 62%, while the other 38% is explained by other factors outside the variables studied. As well as the FV which has a value of 0.362, defines that FV is influenced by the independent and intervening variables PROF, LQD and FND is only 36.2% while the other 63.8% is explained by other factors outside the variables studied.

### 4.4 Hypothesis Test

#### 4.4.1 Path Coefficient Analysis

Indicator	Original Sample	T Statistics	P-Value	Result
PROF → FV	0.135	1.463	0.144	H1 Rejected
LQD → FV	-0.039	0.310	0.757	H5 Rejected
PROF → FND	0.391	7.355	0.000	H2 Accepted

FND → FV	0.542	4.406	0.000	H3 Accepted
LQD → FND	0.585	10,788	0.000	H6 Accepted

Table 5. Path Coefficient

The hypothesis can be accepted if the p-values <0.05 or t-statistics >1.96. The relationship between Profitability and Firm Value is not significant because it has a t-statistic value of 1.463 or <1.96 and p-values of 0.144 or >0.05. The value of Original Sample is 0.135 indicates that there is a positive relationship between Profitability and Firm Value. It can be concluded that the relationship between Profitability and Firm Value is positive but not significant, so H1 is rejected. This result is in line with [3] which found that profitability has no effect on Firm Value. Companies should not only rely on high profits to attract investors, but also have to see other factors that able to increase Firm Value.

The relationship between Liquidity and Firm Value is also not significant because the t-statistic value is 0.310 or <1.96 and the p-value 0.757 or >0.05. The original Sample value is -0.039 indicates that the relationship between liquidity and Firm Value is negative. It can be concluded that the relationship between Liquidity and Firm Value is negative but not significant, so H5 is rejected. This result is in line with [26] which explained that the more liquid means that the more effective the company is to pay their current liabilities by using their current assets, such as cash or securities. But a high LQD can also mean that the company has large investments that allow obsolescence to occur before the investment is sold, that making a shareholder does not expect a high LQD value.

Financial Distress variable which is calculated by mathematical calculations using Altman's Z-score, where the higher Z-score, means that the lower possibility of a company to be in Financial Distress condition. By theory definition, the higher Financial Distress, the more likely the company experienced the distress. So, it can be said that the relationship between the financial distress variables as proxied by the Z-score formula is contradictory to its own theory definition.

The relationship between Profitability and Financial Distress is significant because it has a t-statistic value of 7355 or >1.96 and p-values of 0.000 or <0.05. The original Sample value is 0.391 indicates a positive value in mathematical calculations, but negative in theory. It can be concluded that there is a significant negative relationship between Profitability and Financial Distress, so H2 is accepted. The higher profitability, the lower the possibility of the company will experience Financial Distress because the company has a high profit that can be used to pay its obligations. Stable profit is important for the company in showing its ability to rise and avoid difficult financial conditions. This result is in line with [10], [27] which found that



profitability has a significant negative effect on Financial Distress. If the company generates high profit, it indicates that the managers are doing well on their job and benefiting investors. Effective use of assets increased the value of profitability, so that the company has a sufficient fund and efficient on running its business [28].

The relationship between Financial Distress and Firm Value is significant because it has a t-statistic value of 4.406 or > 1.96 and a p-value of 0.000 or < 0.05. The Original Sample value is 0.542 indicates a positive value in mathematical calculations, which means that the relationship between Financial Distress and Firm Value is negative in theory definition. So, it can be concluded that the relationship between Financial Distress and Firm Value is significantly negative, so H3 is accepted.

The relationship between Liquidity and Financial Distress is significant because it has a t-statistic value of 10.788 or > 1.96 and a p-value of 0.000 or < 0.05. The original Sample value is 0.585 indicates a positive value in mathematical calculations and negative in theory definition. It can be concluded that the relationship between Liquidity and Financial Distress is significantly negative, which means the more liquid the company, the better and healthier the company in managing its funds and the less likely the company to experience Financial Distress, so H5 is accepted. This result is in line with [10] which found that there is a significant negative relationship between Liquidity and Financial Distress. If the company is able to pay its short-term obligations, the company will also avoid the financial crisis.

#### 4.4.2 Mediation Test

Mediation Test is conducted to see whether there is a mediating effect of Financial Distress on Profitability and Firm Value, as well as Liquidity and Firm Value or not. The results of the mediation test can be seen in the following table:

##### Specific Indirect Effects

Indicator	Original Sample	Mean	T Statistics	P-Value	Result
PROF→ FND→ FV	0.212	0.202	3,507	0.000	H4 Accepted
LQD → FND→ FV	0.318	0.303	4.329	0.000	H7 Accepted

**Table 6.** Total Indirect Effects

The mediating effect of Financial Distress on Profitability and Firm Value is significant because it has a t-statistic level of significance of 3,507 or > 1.96 and p-values of 0.000 or < 0.05. The original Sample value is 0.212 indicates that the relationship is positive. Therefore, it can be concluded that there is a mediation effect and a significant positive relationship

between Profitability and Firm Value through Financial Distress, which means that mediation is proven and H4 is accepted.

Likewise, the mediating effect of Financial Distress on Liquidity and Firm Value is also significant because it has a t-statistic significance level of 4,329 or > 1.96 and p-values of 0.000 or < 0.05. The original Sample value is 0.318 indicates that the relationship is positive. Therefore, it can be concluded that there is a mediation effect and a significant positive relationship between Liquidity and Firm Value through Financial Distress, which means that mediation is proven and H7 is accepted.

It can be said that there is perfect mediation by Financial Distress on Liquidity and Firm Value as well as on Profitability and Firm Value. Perfect mediation occurs due to the absence of a direct relationship between Profitability and Liquidity to Firm Value, so that through Financial Distress, it will create an indirect relationship between Profitability and Liquidity to Firm Value.

## 5. CONCLUSIONS AND SUGGESTIONS

Signaling theory provides investors with information about the companies that can provide signals to investors in making investment decisions. The information provided can be in the form of information about the company's financial performance that is presented by the company's Profitability and Liquidity, which will later be a good or bad signal based on the company's Profitability and Liquidity value. Information related to financial statements will become a knowledge for investors about the company so it can help minimize the occurrence of information asymmetry because the information obtained by investors through financial statements is equivalent to information held by management.

The findings of the research conducted by testing the Profitability, Liquidity, Financial Distress and Firm Value variables indicate that Profitability and Liquidity have no direct effect on Firm Value, but have an indirect effect through Financial Distress. Investors can not only look at the Profitability and Liquidity value to see the value of the firm, because it can not show the overall financial condition. For this reason, investors must also look at the financial condition in terms of whether the company is in distress or not, which can be an intermediary for Profitability and Liquidity in increasing the value of the company. Companies that do not experience Financial Distress will be preferred by investors because they are considered to have a long-term sustainability. Thus, this study also proves that Financial Distress has a negative relationship towards Firm Value.

This study has several limitations, such as the limitations of data and scope, as well as the indicator that financial performance used to assess companies that only look at the ratio of Profitability and Liquidity which is Return on Asset and



Current Ratio. Suggestions for further researchers is to use other financial ratios and indicators such as solvency ratios, turnover ratios, earning quality, earning management, growth, etc. that are more representative in measuring the Firm Value.

## AUTHORS' CONTRIBUTIONS

This research contributes to companies that want to maximize their company value, also being a reference and additional literature for other researchers, related to the mediating role of Financial Distress in predicting the effect of Profitability and Liquidity.

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