

The Effect of Profitability and Liquidity on Firm Value with Financial Distress As A Mediating Variable

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ABSTRACT

Financial distress is a phase that precedes the state in which a business faces incapacity or failure, which can even lead to bankruptcy. If a company experiences a lack of funds for internal financing, a solution can be found by utilizing debt as a source of external funding from other parties. Business failure and the risk of bankruptcy are often fears in a competitive business environment. Financial distress arises when a company is unable to fulfil its payment obligations or repay its debts. For internal companies, bankruptcy analysis is useful as an early warning against potential bankruptcy, providing an opportunity to maintain business continuity or sustainability. Therefore, the risk of bankruptcy can be minimized through proper analysis, allowing for a quick improvement. Some commonly used models to analyze corporate financial distress include the Altman, Springate, and Zmijewsk models. This study aims to analyze and identify the influence of fundamental factors represented by ratios, such as ROA Ratio, Current Ratio, and Firm Value, on the condition of Financial Distress in mining sector stocks on the Indonesia Stock Exchange. The research will focus on the impact of Profitability and Liquidity on Firm value, with Financial Distress as a mediating variable. The research results can be described as follows ROA does not affect Firm Value. The current Ratio does not affect Firm Value. ROA does not affect Financial Distress. The current Ratio has a positive and significant effect on. Financial Distress, Financial Distress has a significant positive effect on Firm Value. Financial distress cannot mediate the relationship of Profitability (ROA) to Firm Value. Financial distress cannot mediate the relationship of Liquidity (Current Ratio) to Firm Value.

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INTRODUCTION

One of the factors driving the growth of companies that go public is the high value of the capital market. The capital market reflects the total value of a company's assets in the market, which makes it an important consideration factor for potential investors. Companies that have a high capital market value give a positive indication to share buyers or investors regarding the health of the company. This principle is in line with signalling theory, where investors capture good or bad signals from the signal

object, which in this context is the value of the Company (Patty JP, 2023).

The evaluation of company performance can be greatly influenced by the size of the company, which may be the most crucial factor. In ordinary situations, large companies should have an advantage over smaller companies (Sukanti & Rahmawati, 2023). Under normal conditions, large companies should be stronger than small companies. With the status of large companies, they have the capacity for better access to capital markets and credit markets. However, in economic conditions in crisis, large companies will be at greater risk than small companies because usually large companies have more debt. Several studies explain that firm size has become the most important factor in influencing financial performance (Fahru Rachman et al., 2023).

Financial distress can be interpreted as early signs of potential bankruptcy caused by a decline in financial condition. Financial difficulties arise when the company's liabilities exceed the value of the company's assets, size, and profits (Arief H et al., 2021). Financial Distress arises when the company is no longer able to fulfil or pay off payment obligations or in other words the company can no longer meet its debt obligations (Uyi Michael et al., 2020). Financial distress refers to a situation that occurs before a business experiences incapacity or failure, and ultimately, can lead to the worst condition in business, namely bankruptcy. Financial distress can be identified from liquidity difficulties to the point where the company is considered unable to pay off its financial obligations (Arief et al., 2023). The impact of financial distress has caused many public companies on the stock exchange to experience delisting. Related to this phenomenon, it is very important for investors, creditors, and company stakeholders to have a mechanism that can provide early warning (Kamaluddin et al., 2019). Liquidity refers to the capacity of a company to fulfil its short-term responsibilities, such as accounts payable, dividend payable, tax payable, and so on, using its current assets. The level of liquidity reflects the extent to which a company is able to pay its maturing obligations. (Tanapuan EY, 2022).

Profitability

By observing the profitability ratio, company managers can assess and determine whether a company is profitable (Subiyanto IG & Siagian HL, 2022). A high level of profitability reflects high efficiency, and therefore, creating profits, is often considered as one indicator of business success in a certain period of time. In this study, ROA (Return on Asset) is used. This ratio evaluates the extent to which the investment that has been made can generate profits as expected. This investment is equivalent to the value of assets invested or submitted by the company. ROA (Return on Assets) is a parameter that describes how effectively a company generates profits based on its total assets. ROA provides insight to managers, investors, or analysts about the extent of efficiency in managing the company's assets to create revenue. The Formula of $ROA = \frac{\text{Net income} + \text{After Tax Interest Cost}}{\text{Average Total Assets}}$

Liquidity

Liquidity is an evaluation of a company's ability to meet its short-term obligations, including its ability to pay these obligations at any time or at maturity. Liquidity ratios are also very important for investors

to evaluate the financial condition of a business and determine whether or not it is worth investing in. As an illustration, companies need to have the flexibility of funds to pay short-term bills. Therefore, a low level of liquidity can be a warning indicator (Rahma, 2020).

Current ratio is a useful method in forecasting potential financial difficulties that may be faced by a company. The level of a company's ability to meet long-term obligations can be anticipated from its level of liquidity, where the higher the liquidity, the greater the ability to meet these obligations (Diyanto, 2020). The Formula of Current Ratio = $\frac{\text{Current Asset}}{\text{Current Liabilities}}$

Financial Distress

Financial distress is the financial state of a company in which difficulties arise in fulfilling its obligations due to a lack of ability to generate adequate profits (Rawal et al., 2023). Edward Altman first introduced Z-Score Analysis, which is designed to identify the likelihood of corporate bankruptcy and can also serve as a metric to evaluate overall financial performance. In 1968, Altman introduced an early model for forecasting financial distress known as Altman's Z-Score. This model is still considered very relevant for use in forecasting bankruptcy, grey zone, or financial health conditions. In 1995, there were adjustments to the model that could be applied to forecast potential bankruptcy in companies, both in the manufacturing and non-manufacturing sectors (Bajaj et al., 2022). Altman made improvements to his model by actualising a formula that can be applied specifically to non-manufacturing companies. By using this model, it can be applied to predict the potential bankruptcy of non-manufacturing companies, both those that have gone public and those that have not gone public (JP, 2023). The following formula is refined by Altman $Z = 6.56 X1 + 3.26 X2 + 6.72 X3 + 1.05 X4$

Where:

X1 = Working capital/total assets

X2 = Retained earnings/total assets

X3 = Profit before interest and tax/total assets

X4 = Market value of share capital / Book value of total debt

The following Altman Zscore reference value is based on market value

Zscore <1.10 = Unhealthy Condition

Zscore = 1.10 Fragile Condition

Zscore >2.6 Healthy Condition

Firm Value

Firm Value can be estimated with reference to the share price offered to other parties, namely investors, and reflects an overall evaluation from the investor's point of view of the company's capital value. The welfare of owners and shareholders can be indicated positively by the increase in the share price set, which will reflect an increase in the value of the Company (Firm Value).(Tanapuan EY, 2022)

The Firm Value formula is

$$FV = [(P*Q) + Debt] / Total Assets]$$

Description:

FV = Firm Value

P = Closed price

Q = Number of shares outstanding

Debt = Book value of Total Debt

TA = Total Assets

Hypothesis

Profitability to Firm Value

When a company's profitability, reflected through return on assets, is high, it shows that in carrying out its operational activities, the company can manage its resources in an effective and efficient manner. This ability allows the company to generate optimal profits, provide maximum returns to investors, and increase investment value. The more superior the company's ability to create profits, the more promising the company's prospects in the future. This creates a positive signal for investors, which in turn increases the demand for the company's shares so that the stock price rises, and ultimately Firm Value increases (Wanti & Sari, 2022).

H1 : Profitability has a positive effect on Firm Value on the object of oil and gas mining companies going public on the IDX.

Liquidity to Firm Value

When the liquidity level is high, it indicates that the company is in a positive condition. Indirectly, this can increase investor interest in buying company shares and result in an increase in the selling price of shares. The increased selling price of shares will ultimately increase the value of the company or Firm Value (Suryani & Yeni, 2022).

H2 : Liquidity has a positive effect on Firm Value on the object of oil and gas mining companies going public on the IDX.

Profitability to Financial Distress

An increase in return on assets indicates an increase in company performance. Conversely, if profitability is low, the company may be less efficient in managing its assets to create profits, potentially causing losses and negative cash flow. This is because the higher the level of ROA which is an indicator of the Company in generating profits where these profits are used for operational activities and to pay the Company's obligations. So that in the end it will avoid the risk of financial distress (Arief et al., 2023). Research shows that Return on Asset (ROA) is positively and significantly related to Financial Distress in Private Bank companies in Indonesia (Chou et al., 2023). In contrast, Tarighi H, Appolloni A, Shirzad A, Azad A found that ROA has a negative and significant effect on Financial (Tarighi et al., 2022).

H3 : Profitability (ROA) has a positive effect on financial distress of oil and gas mining companies on the Indonesia Stock Exchange.

Liquidity to Financial Distress

When the liquidity ratio is high, the company's assets may not be utilised efficiently, which can reduce the company's ability to generate profits. This can increase the risk of the company experiencing financial difficulties. (Kisman & Krisandi, 2019) When a company's ability to pay off debt is higher, the company's financial health will improve (Oktavian & Handoyo, 2023).

H4 : Liquidity (current assets / current liabilities) has a positive effect on financial risk (financial distress) on the object of oil and gas mining companies going public on the IDX.

Financial Distress to Firm Value

H5 : Financial Distress has a negative effect on Firm Value on the object of oil and gas mining companies going public on the IDX.

Research stated (Dewi M et al., 2021) that low Firm Value will potentially increase the possibility of the company experiencing Financial Distress. In other research (Elisah & Heliani, 20213) that Firm value has no effect on financial distress.

Profitability, Financial Distress and Firm Value

H6 : Financial Distress can mediate the relationship between Profitability and Firm value. on the object of oil and gas mining companies going public on the IDX.

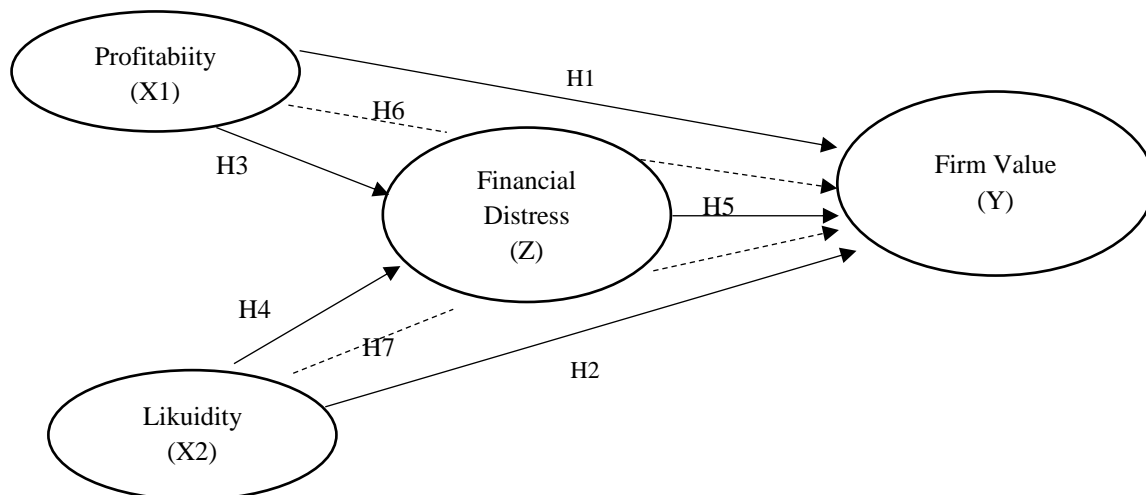
Profitability is one of the elements that have an impact on Firm Value. Profitability is a reflection of the company's ability to generate profits which in turn can increase value for shareholders. When the increase in Profitability is getting better, this will indicate positive prospects for the future, so that Firm value will be higher in the eyes of investors. These positive indications will keep the company away from financial distress (Wulandari C & Efendi D, 2022).

Liquidity, Financial Distress and Firm Value

H7 : Financial Distress can mediate the relationship between Liquidity and Firm value. on the object of oil and gas mining companies going public on the IDX.

Companies with high liquidity will have an impact on the company's avoidance of financial distress conditions, this will increase investor confidence in the company which in turn will increase the Company's value (Zelie, 2019). In contrast to other researchers (Stepani PN & Nugroho L, 2023) suggests that a high level of liquidity can keep the company away from financial difficulties but this condition does not make the company's value increase (Stepani PN & Nugroho L, 2023).

Conceptual Framework



METHOD

This research adopts a descriptive method, with the aim of obtaining an understanding of independent variables, either one or more variables, without making comparisons or looking for relationships between these variables with each other. Population and Sample

The population of this study were 13 companies engaged in oil and gas mining and the research sample was taken based on purposive sampling technique. Sampling is determined based on criteria:

1. Oil and gas mining sector companies listed on the IDX which are listed on the IDX during

2017-2022.

2. Oil and gas mining sector companies that during the 2017-2021 period have never experienced delisting.

Based on the above criteria, there are 7 companies that have been sampled in a period of 5 years (35).

Data Testing

This study uses Eviews 9 software in helping test data. The following data will be tested in this study

1. Panel Data Test

This test is conducted to combine cross data with time series data (Gozali & Nasehudin, 2019).

2. Chow Test

This chow test is used to select the right panel data regression model between common effect or fixed effect (Basuki & Prawoto, 2017).

3. Hausman Test

This test is used to select the right panel data regression model between Random Effect or Fixed Effect (Basuki & Prawoto, 2017).

4. Lagrange Multiplier Test

This test is used to select the right panel data regression model between Random Effect or Common Effect (Basuki & Prawoto, 2017).

Hypothesis Testing

Based on the hypothesis submission above, Multiple Linear Regression Analysis is used using a confidence level of 95% or Alpha 5%. The Multiple Linear Regression formula, as follows:

$$Y = c + a.X1 + b.X2 + c.X3 + d.X4 + e$$

Description

Stock Price = Y, Independent Variables = X1, X2, X3, X4

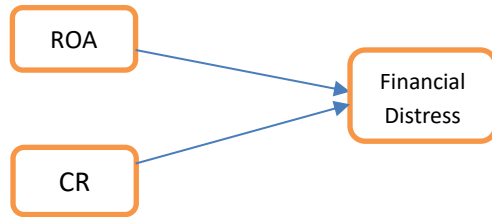
Constant = c, Error = e

RESULTS AND DISCUSSION

The purpose of this study is to examine and discuss how financial performance, namely the level of Profitability which is represented by Return on Assets, the level of Liquidity which is represented by the Current Ratio,) to Firm Value (Company Value) and the Predictive Value of bankruptcy using the Altman Zscore model as a Mediating variable in oil and gas mining companies on the Indonesia Stock Exchange. The calculation uses a panel data regression model using the Common Effect (CEM), Fixed Effect (FEM) and Random Effect (REM) approaches. Then determine which is the best of the three models by testing the chow test, Hausman test and Langrange Multiplier test.

Panel Regression Calculation

Sub-Structural 1



Chow Test of Sub Structural 1

Redundant Fixed Effects Tests
Equation: Untitled
Test cross-section fixed effects

| Effects Test | Statistic | d.f. | Prob. |
|--------------------------|-----------|--------|--------|
| Cross-section F | 1.375302 | (6,23) | 0.2663 |
| Cross-section Chi-square | 9.810662 | 6 | 0.1329 |

If the probability > 0.05 then the decision uses the Common Effect Model (CEM) approach. If the probability < 0.05 then the decision uses the FEM (Fixed Effect Model) approach. In the chow test results, the probability value is 0.1329 which is greater than 0.05 so that the Common Effect Model (CEM) is selected. If the Chow Test chosen is CEM, there is no need to do the Hausman Test so that the Legrange Multiplier (LM) Test is immediately performed.

Legrange Multiplier (LM)

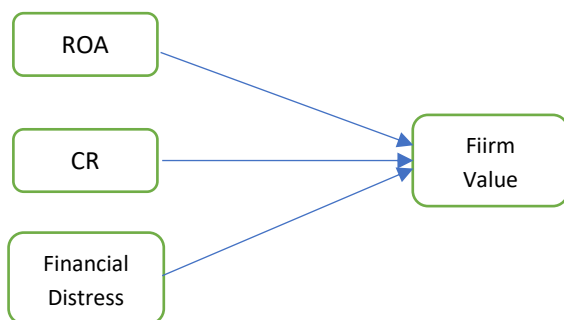
Table – Legrange Multiplier Sub Structural 1

Lagrange Multiplier Tests for Random Effects
Null hypotheses: No effects
Alternative hypotheses: Two-sided (Breusch-Pagan) and one-sided (all others) alternatives

| | Test Hypothesis | | |
|----------------------|-----------------------|-----------------------|-----------------------|
| | Cross-section | Time | Both |
| Breusch-Pagan | 0.006620 (0.9352) | 0.570504 (0.4501) | 0.577124 (0.4474) |
| Honda | -0.081364 (0.5324) | -0.755317 (0.7750) | -0.591623 (0.7229) |
| King-Wu | -0.081364 (0.5324) | -0.755317 (0.7750) | -0.631342 (0.7361) |
| Standardized Honda | 0.341740 (0.3663) | -0.544230 (0.7069) | -3.353842 (0.9996) |
| Standardized King-Wu | 0.341740 (0.3663) | -0.544230 (0.7069) | -3.359855 (0.9996) |
| Gourieroux, et al. | -- | -- | 0.000000 (1.0000) |

The table above shows the probability value of 0.9352 where this value is greater than 0.05 so that the Common Effect Model (CEM) is chosen.

Sub-Structural 2



Chow Test of Sub Structural 2

Redundant Fixed Effects Tests
Equation: Untitled
Test cross-section fixed effects

| Effects Test | Statistic | d.f. | Prob. |
|--------------------------|-------------|--------|--------|
| Cross-section F | -3.646517 | (6,22) | 0.9890 |
| Cross-section Chi-square | -166.523082 | 6 | 0.9759 |

If the probability > 0.05 then the decision uses the Common Effect Model (CEM) approach. If the probability < 0.05 then the decision uses the FEM (Fixed Effect Model) approach. In the chow test results, the probability value is 0.9759 which is greater than 0.05 so that the Common Effect Model (CEM) is selected. If the Chow Test selected is CEM, there is no need to do the Hausman Test so that the Legrange Multiplier (LM) Test is immediately carried out.

Legrange Multiplier (LM)

Lagrange Multiplier Tests for Random Effects
Null hypotheses: No effects
Alternative hypotheses: Two-sided (Breusch-Pagan) and one-sided (all others) alternatives

| | Test Hypothesis | | |
|----------------------|----------------------|----------------------|----------------------|
| | Cross-section | Time | Both |
| Breusch-Pagan | 5.233078 (0.2220) | 1.118978 (0.2901) | 6.352057 (0.0117) |
| Honda | 2.287592 (0.0111) | 1.057818 (0.1451) | 2.365562 (0.0090) |
| King-Wu | 2.287592 (0.0111) | 1.057818 (0.1451) | 2.279666 (0.0113) |
| Standardized Honda | 2.991599 (0.0014) | 1.362491 (0.0865) | 0.178793 (0.4291) |
| Standardized King-Wu | 2.991599 (0.0014) | 1.362491 (0.0865) | 0.097685 (0.4611) |
| Gourieroux, et al. | -- | -- | 6.352057 (0.0163) |

The table above shows the probability value of 0.2220 where this value is greater than 0.05 so that the Common Effect Model (CEM) is chosen.

Hypothesis Structural 1

T- Test

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|----------|-------------|------------|-------------|--------|
| C | 3.950045 | 0.402121 | 9.823032 | 0.0000 |
| CR | 5.70E-05 | 1.69E-05 | 3.374342 | 0.0021 |
| ROA | 0.006346 | 0.020626 | 0.307693 | 0.7605 |

The table shows the relationship between Liquidity represented by Current Ratio on Financial Distress and Profitability represented by ROA on Financial Distress.

In the relationship of the Liquidity variable represented by Current Ration on Financial Distress with a probability value of 0.0021 smaller than 0.05 and T-count 3.374 > t-table 2.036. So it can be concluded that Liquidity has a significant effect on Financial Distress. This is in line with previous research by Diyanto (Diyanto, 2020). It is known that the value of Liquidity is the Company's ability to meet its short-term obligations so that from this ability it can be estimated that the Company will be able to meet its long-term obligations. The greater the level of liquidity, the greater the Company's ability to meet its long-term obligations so that it will avoid the risk of Financial Distress.

In the relationship between the Profitability variable represented by the ROA ratio on Financial Distress with a probability value of 0.7605 greater than 0.05. So it can be concluded that Profitability has no effect on Financial Distress. In line with research by Holili M & Paramita (Holili & Paramita, 2021). In this study, ROA is not proven to predict Financial Distress because an increase in ROA does not consistently cause a decrease in Financial Distress. If the company has adequate cash flow and adequate liquidity and manages expenses efficiently, ROA has no significant impact.

Hypothesis of Structural 2

T-Test

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|--------------------|-------------|-----------------------|-------------|----------|
| C | -0.725925 | 1.041124 | -0.697251 | 0.4914 |
| ROA | -0.034559 | 0.025713 | -1.344049 | 0.1897 |
| CR | -5.63E-07 | 2.48E-05 | -0.022696 | 0.9821 |
| FD | 0.502566 | 0.231120 | 2.174480 | 0.0383 |
| R-squared | 0.216295 | Mean dependent var | | 1.761875 |
| Adjusted R-squared | 0.132326 | S.D. dependent var | | 1.977891 |
| S.E. of regression | 1.842386 | Akaike info criterion | | 4.176469 |
| Sum squared resid | 95.04285 | Schwarz criterion | | 4.359686 |
| Log likelihood | -62.82350 | Hannan-Quinn criter. | | 4.237200 |
| F-statistic | 2.575903 | Durbin-Watson stat | | 0.584196 |
| Prob(F-statistic) | 0.073775 | | | |

The table shows the relationship between Liquidity represented by Current Ratio to Firm Value and Profitability represented by ROA to Firm value and Financial Distress Variables to Firm Value.

In the relationship of Profitability variable represented by ROA ratio to Firm Value with probability value 0.1897 greater than 0.05. So it can be concluded that Profitability has no effect on Firm Value. The results of this study are in line with previous researchers by Anisa H, Suryandari D (Anisa & Suryandari, 2021) high ROA is not always a determining factor for Firm value for investors, even though profits look positive but are not accompanied by inefficient asset management, it can raise doubts for investors.

In the relationship of liquidity variables represented by Current Ration to Firm Value with a probability value of 0.9821 greater than 0.05. So it can be concluded that Liquidity has no effect on Firm Value. This research is in line with the results of Darmawan's research (Dharmawan et al., 2023). Liquidity is an indicator of the Company's ability to meet its short-term obligations and has no impact on the growth of Firm Value Investors are less interested in the Company's internal assessment in meeting its short-term obligations. Investors will focus more on long-term ratios because they have more value and greater impact on investment returns.

In the relationship between the Financial Distress variable and Firm Value with a probability value of 0.0383 smaller than 0.05 and T-count 2.174 > T-table 2.048. So it can be concluded that Financial Distress has a significant effect on Firm Value. The results of this study are in line with the research of Elisah S (Elisah & Heliani, 20213). Companies experiencing financial difficulties will reduce investor interest in investing so that in the end the company value will decrease.

Sobel Test

1. ROA – Financial Distress -Firm Value

| Input: | | Test statistic: | | Std. Error: | p-value: |
|----------------|----------|-----------------|------------|-------------|------------|
| a | 0.006346 | Sobel test: | 0.30463567 | 0.01046917 | 0.76064365 |
| b | 0.502566 | Aroian test: | 0.27724659 | 0.01150342 | 0.78159077 |
| s _a | 0.020626 | Goodman test: | 0.34216605 | 0.00932087 | 0.73222593 |
| s _b | 0.231120 | Reset all | Calculate | | |

Based on the results of the Sobel Test calculation, the probability value of 0.760 is greater than 0.05 so it can be concluded that financial distress cannot mediate the relationship between profitability (ROA) and firm value.

2. Current Ratio – Financial Distress – Firm Value

| Input: | | Test statistic: | | Std. Error: | p-value: |
|----------------|----------|-----------------|------------|-------------|------------|
| a | 5.70E-05 | Sobel test: | 1.82758082 | 0.00001567 | 0.06761249 |
| b | 0.502566 | Aroian test: | 1.77335075 | 0.00001615 | 0.0761706 |
| s _a | 1.69E-05 | Goodman test: | 1.88711109 | 0.00001518 | 0.05914539 |
| s _b | 0.231120 | Reset all | Calculate | | |

Based on the results of the Sobel Test calculation, the Liquidity value of 0.0676 is greater than 0.05 so it can be concluded that financial distress cannot mediate the Liquidity Relationship (CR) to Firm Value.

CONCLUSION

The results of this study can be summarized as follows:

Profitability (ROA) does not affect Firm Value. This finding is in line with previous research by Anisa H, Suryandari D (Anisa & Suryandari, 2021), indicating that high ROA is not always a determining factor for Firm value to investors. Even though profits appear positive, without efficient asset management, it can raise doubts among investors.

Liquidity (Current Ratio) does not affect Firm Value. This aligns with the findings of research by Darmawan (Dharmawan et al., 2023). Liquidity reflects a company's ability to meet its short-term obligations and does not impact the growth of Firm Value. Investors are less interested in the internal assessment of a company's ability to meet short-term obligations. They tend to focus more on long-term ratios as they hold more value and have a greater impact on investment returns.

Profitability (ROA) does not affect Financial Distress. Consistent with research by Holili M & Paramita (Holili & Paramita, 2021), ROA is not proven to predict Financial Distress because an increase in ROA does not consistently lead to a decrease in Financial Distress. If a company has adequate cash flow, liquidity, and efficient cost management, ROA will not have a significant impact.

Liquidity (Current Ratio) has a positive and significant effect on Financial Distress. This is consistent with previous research by Diyanto (Diyanto, 2020). Liquidity indicates a company's ability to meet its short-term obligations, and from this ability, it can be inferred that the company will be able to meet its long-term obligations. The higher the liquidity level, the greater the company's ability to meet its long-term obligations, thus avoiding Financial Distress risk.

Financial Distress has a positive and significant effect on Firm Value. This finding aligns with the research by Elisah S (Elisah & Heliani, 2021). Companies experiencing financial difficulties will reduce investor interest in investing, ultimately leading to a decrease in Firm Value.

Financial distress cannot mediate the relationship between Profitability (ROA) and Firm Value. This is evident from the results of the Sobel Test calculation.

Financial distress cannot mediate the relationship between Liquidity (Current Ratio) and Firm Value.

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