

Determinant Of Financial Distress In Manufacturing Companies

Hermiyetti^{a,1}, Donny Dharmawan^{b,2}, Listiana Sri Mulatsih^{c,3}, Alfiana^{d,4}, Samuel PD Anantadjaya^{e,5}

^aProdi : Akuntansi, Jurusan : Akuntansi, Universitas Bakrie, Provinsi : Jakarta Selatan;

^bProdi : Manajemen, Fakultas Ekonomi Universitas Krisnadwipayana (FE UNKRIS), Jakarta;

^cProdi : Manajemen, Jurusan : Manajemen, Universitas Bung Hatta, Provinsi : Sumatera Barat;

^dProdi : Manajemen, Jurusan : manajemen Universitas Muhammadiyah Bandung, Jawa Barat;

^eMBA Program, Faculty Member, IPMI Business School, Kalibata, Jkt Selatan, DKI Jaya

*hermiyetti@bakrie.ac.id, ²donny28dh@gmail.com, ³listiana@bunghatta.ac.id, ⁴alfiana.dr@umbandung.ac.id, ⁵ethan.eryn@gmail.com

* corresponding author

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ABSTRACT

Financial distress is a picture of a continuous decline in a company's financial performance that needs to be predicted and minimized. The occurrence of financial distress begins with a decline in the company's financial condition which begins with the company's inability to meet its short-term obligations. The purpose of this study is to determine and evaluate the effect of Return on Assets (ROA), company size and also Debt to Equity Ratio (DER) on financial distress. Regression analysis and quantitative methods are used in the research process. Manufacturing companies that consistently release their financial reports during 2019-2022 and are listed on the Indonesia Stock Exchange are examples. The sampling method used in this study was purposive sampling and succeeded in obtaining 40 samples from 10 companies. Data were analyzed using Partial Least Squares-Structural Equation Modeling (PLS-SEM). The results of this study indicate that ROA has a significant effect on financial distress. Meanwhile, company size and DER do not affect financial distress in manufacturing companies in the 2019-2022 period. The implications of the results of this study for manufacturing company management can be an indicator of corrective actions before the company experiences financial distress or has the potential to go bankrupt.

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1. Introduction

Along with the progress of the times and technological developments in the current global economy, it has shown rapid progress. The globalization and spread of economy are reflection that indicate that the world economy is getting better (Iskandar et al., 2023). The conveniences of this era must be utilized in business activities supported by effective and efficient management to gain profits. Competitive business maintaining financial stability for companies is the most important thing so that the company becomes more successful and can continue to run the company, especially in the manufacturing sector (Asad & Yousaf, 2014). Due to the intense level of competition, every business must continuously improve its basic management system to compete with other competitors and anticipate financial distress. In recent years the world, especially in Indonesia has faced significant economic problems due to the Covid-19 pandemic which has significant impact business in Indonesia. This has a great deal to do with a company's survival, even though almost all companies in various industries have same problems, namely financial difficulties commonly known as financial distress conditions (Wilamsari et al., 2022).

One of the most important aspects of the company is the financial aspect (Santoso & Ariefiantoro, 2019). Financial reports are a form of management accountability in managing company resources. Financial reports must meet the objectives, rules and accounting principles in accordance with generally accepted standards in order to produce financial reports that are accountable and useful for each user (Han & Maharani, 2022). Finance is an important factor in maintaining the stability of a company for profit. If the company experiences financial difficulties, the company will take actions that can restore its original financial position. The company should be able to take actions to anticipate financial difficulties such as financial analysis and prediction (Erayanti, 2019). Financial prediction analysis is a way of identifying financial performance so as to find the most important indicators that lead to potential bankruptcy or not due to financial distress experienced by company (Komala & Triyani, 2019).

The phenomenon of company delisting in 2018 shows that financial difficulties have not been resolved, so bankruptcy is very likely to occur. Since August 2020, the manufacturing sector experienced very strong contraction where utility and productivity decreased drastically by up to 40%. Whereas before the pandemic, the average utilization of manufacturing companies could be reach 76.29% (<https://www.cnbcindonesia.com/>, 2020). Data from the Purchasing Manager Index (<https://pmi.spglobal.com>) shows that manufacturing enterprises performance declined in April 2020, hitting 27.5 from 45.3. Decrease in performance is significant shift was recognised as possible cause of financial distress. The source of funds obtained by the company can come from business activities, loans, or transactions in the capital market. The funds obtained to become the company's capital to fulfill its obligations to other parties such as the payment of wages, additional working capital including investment, and fulfillment of obligations to stakeholders in the form of dividends (Desai & Desai, 2021).

There are several things that can cause financial distress in companies, including profitability. Profitability is the ratio used to measure a company's ability to make profit (Mahardika & Mulyawan, 2023). Profitability also provide a measure of the effectiveness of management in a company. This ratio can be used by comparing between components that are in the financial statements in one or several periods with the aim that company's development, both increases and decreases within a certain period of time, can be seen so that it can simultaneously look for the causes of these changes (Opitalia & Zulman, 2019). In this study, profitability proxied by Return on Assets (ROA) compared the rate of return of the company assets by linking net income to total assets owned by the firm. The results of calculating return on assets describe the profitability of a company where the greater ROA value, the better of company performance and minimizes the occurrence of financial distress (Silvia & Yulistina, 2022). ROA shows the company's effectiveness in generating profits by optimizing its assets (Sulistiyawati et al. 2021).

Apart from profitability, there are other factors that influence financial distress, namely leverage. Tanjung (2023) leverage is ratio used to measure the extent to which a company's assets are financed with debt. This means that the large amount of debt used by the company to finance its business activities when compared to using its own capital. In this study leverage proxied by Debt to Equity Ratio (DER) which is the ratio of total debt of the firm with total equity or capital owned by the firm (Santoso & Junaeni, 2022). DER shows the level of company risk, the higher of DER, the greater composition of long-term liabilities owned by the company, which increases the risk of default. In obtaining funds, the company will choose a source of funds with a small risk and improve the management of the company so as to obtain large profits. Furthermore, debt has an advantage in the corporate taxes as interest is deductible as an expense. The companies not only required to produce products, but also must be able to manage their capital structure (Diyanto, 2020).

The ability of financial ratios in analyzing financial distress cannot be separated from the number of company assets as reflected by the size of the company. The more assets owned, the company is classified as a large firm size, and vice versa. According to (Suharti et al., 2020), the large companies are considered of low-risk because they have a large capital structure. The research was conducted by (Natalia & Rudiawarni, 2022) showed that firm size could strengthen financial ratios (leverage, liquidity, and operating cash flow) in predicting financial distress. On the contrary, (Santoso et al., 2023) describe firm size weakens the relationship between financial ratios on financial distress. It is because companies with small assets are unable to pay off their liabilities are not able to run operations optimally, so they have the potential to experience financial problems.

When the size of a company is large, it can be said that this company can avoid financial distress. This is because company's certainly have the trust of stakeholders and have sufficient resources to survive in the midst of a crisis.

The selection of manufacturing companies as research samples, because this sector has an important role in Indonesian economy during the Covid-19 pandemic. In addition, manufacturing companies have stable net income compared to other corporate sectors. Furthermore, Indonesia is also the largest manufacturing industry base in ASEAN and is one of five countries, namely China (28.8%), South Korea (27%), Japan (21%), Germany (20.6%), and Indonesia (20.5%) whose manufacturing industry sector is able to contribute above average (17%) to the country's economy.

The research objectives to be achieved with this research are to determine the partial effect of profitability (ROA), leverage (DER), Size Company on financial distress in manufacturing companies listed in the Indonesia Stock Exchange for the 2019-2022 period.

Return on Asset (ROA)

Profitability is measured by the difference between the income received and the costs incurred by the company. Profitability shows the company's ability to generate profits by utilizing its total assets (Santoso & Widowati, 2022). The Role Of In Disclosing Firm Value. *Jurnal Ekonomi Manajemen*. 8(1). 71-78 Measuring profitability is important for manufacturing companies cause it is a measure of success and become basis for assessing manufacturing sector health to compete and survive as business organisation (Setyaningsih & Gunarsih, 2018). The profitability can measure financial distress cause by showing the effectiveness of the use of company assets will reduce costs incurred by the company, the company will obtain savings and will have sufficient funds to run its business. By generating profitability effectively, investor confidence will also increase in manufacturing companies so that they are expected to improve the economy (Sasongko et al., 2021). ROA is a comparison between the rate of return with assets owned which describes how effective the company is in managing assets to earn a profit and show the company's better performance in relation to sales, volume, total asset and investments of the company owner. ROA is the ratio used to measure how much profit gets when the company is running (Widyakto et al. 2023).. Return on Asset (ROA) is chosen as an indicator of financial performance of manufacturing sector because ROA is used to measure the effectiveness of companies in generating profits by utilizing assets owned. This means that the higher profits generated by the company the less the possibility of financial distress. According to the pecking order theory, companies with high ROA generally have relatively little debt (Miswanto et al., 2022).

Debt to Equity Ratio

Leverage ratio measures the level to which the assets of a company are financed by debt. It indicates the companies manage to fulfill their entire liabilities, either its short-term or the long-term. The leverage ratio in this study is proxied by the Debt to Equity Ratio (DER). DER compares long-term debt with own capital to find out the use of long-term debt compared to own capital (Fatmawati & Rihardjo 2017). A high debt to assets ratio means that most of assets are financed by debt. This triggers the occurrence of financial distress, because the greater the burden of the company to cover the obligations and interest charged. DER calculation illustrates the utilization rate of debt proportion to equity. Companies which have greater debt proportion than equity means that the companies use more debt compared to their own capital to fund all the companies activities. The bigger the Debt to Equity is, the smaller the probability of financial distress will be (Santoso et al., 2023).

Size Company

Size company is scale that can be classified as the size of the company according to various ways, including total assets, stock market value, and others (Natalia & Rudiawarni, 2022). Hunafah et al., (2022), the size of the company is the classification of companies including large or small company. Companies that have a large total assets able to classification and be lesslikely to bankruptcy. (Sugiarto, 2009), explaining that the size of the company is as an agent of asymmetric information between the market and the company (Karim et al., 2023). In addition, the size of company can was measured by total net sales. That the higher the sales of a company, the greater the size of the company and the company is said to be stable and also reduce the likelihood of financial

distress. This phenomenon in the competition of each company will run according to its conditions, large companies will have greater access while smaller companies will have smaller access as well, each of these companies must be able to read the market situation market situation in order to expand its business to get the maximum profit.

Financial Distress

Financial distress is a condition of financial decline experienced by a company for several consecutive years which can result in bankruptcy. According to (Akbar & Lanjarsih, 2024), financial distress as a condition in which company cannot or experiencing difficulties in fulfilling its obligations to creditors. The chance of financial distress increases when the company's fixed costs are high or earnings are very sensitive to economic recession. This condition will force companies to incur high costs so that management is forced to make loans to other parties (Aslamiah et al., 2023). Financial distress as possibility that a company cannot fulfill its obligations when they fall due. It leads the company to experience operating

losses and net losses for the current year. The losses will result in capital deficiency due to a decrease in the value of retained earnings used to make dividend payments. If the condition persists, the corporate's total liabilities may exceed the total assets it owns. As such, a company is associated with the experience of financial distress, which eventually, if it is unable to overcome the above conditions, it will lead to bankruptcy (Rudianto, 2013)

2. Method

Quantitative descriptive is the approach that researches used in this study. The data is produced in numerical form, generated from secondary data in financial report, obtained from the Indonesia Stock Exchange (IDX) on its official website. The process of collecting data was obtained by documenting and observing manufacturing companies in Indonesia. Researches also apply literature studies through citing relevant articles journal and books as theoretical basis. The population for this study is manufacturing companies listed on the IDX for 2019-2022 period and sample size is determined by purposive sampling technique. The manufacturing companies were obtained that met the criteria, these are CEKA, CLEO, DLTA, ICBP, INDF, KLBF, MLBI, MYOR, SIDO and ULTJ and which had consistent and complete financial records through the publication of annual report in 2019-2022.

The data analysis techniques use Partial Least Squares-Structural Equation Modeling (PLS-SEM) with the help of SmartPLS version 3.29. SEM-PLS is used in this study because it has several advantage including being able to test direct moderating variable. The analysis stage in PLS-SEM is testing the outer model, inner model, and hypothesis. Test outer model including convergent validity, discriminant validity, composite reliability and also Average Variance Extracted (AVE). While, test inner model consists of R² and the final stage of this test is hypothesis testing. The test criteria are carried out when the t-statistic value \geq t-table (1.96) and the probability value \leq alpha (0.05) it is stated that there is a significant effect of exogenous variables on endogenous variables (Solimun, 2017)

3. Results and Discussion

The results of data processing explain each dependent variable which is explained by statistics, the results obtained using several analyzes are as follows:

3.1. Analysis Outer Model (Measurement Model)

1) Convergent validity, AVE and Composite Reliability

Convergent validity is assessed based on the correlation between variables. The size of construct is considered high if the outer loading value is > 0.70 with correlation between item scores and construct scores. However, in the application of early stage research, getting a value of 0.50 to 0.60 is considered sufficient. AVE is carried out to assess whether an indicator has a higher correlation value than other indicators and the value on AVE should be > 0.5 . While, analysis of composite reliability was conducted to determine the consistency and accuracy of the instrument when measuring a construct. Rated reliable if the value composite reliability > 0.70

Table 1. Outer Loading, Cronbach's Alpha, Composite Reliability and Average Variance Extracted

| Variable | Item Measurement | Outer Loading | Cronbach's Alpha | Composite Reliability | AVE | Conclusion |
|--------------------------------------|---------------------|------------------|---------------------|--------------------------|-------|------------|
| Return on Assets (X1) | ROA.2019 | 0,939 | 0,906 | 0,927 | 0,840 | Reliable |
| | ROA.2020 | 0,958 | | | | Reliable |
| | ROA.2021 | 0,873 | | | | Reliable |
| Debt to Equity Ratio (X2) | ROA.2022 | 0,894 | 0,830 | 0,847 | 0,745 | Reliable |
| | CR.2019 | 0,838 | | | | Reliable |
| | DER.2019 | 0,803 | | | | Reliable |
| | DER.2020 | 0,912 | | | | Reliable |
| | DER.2021 | 0,900 | | | | Reliable |
| Size Company (X3) | DER.2022 | 0,833 | 0,966 | 0,980 | 0,928 | Reliable |
| | SC.2019 | 0,911 | | | | Reliable |
| | SC.2020 | 0,974 | | | | Reliable |
| | SC.2021 | 0,982 | | | | Reliable |
| Financial Distress (Y) | SC.2018 | 0,984 | 0,954 | 0,965 | 0,843 | Reliable |
| | ROA.2019 | 0,930 | | | | Reliable |
| | ROA.2020 | 0,962 | | | | Reliable |
| | ROA.2021 | 0,848 | | | | Reliable |
| | ROA.2022 | 0,928 | | | | Reliable |

^a Source: Processed data, 2024

From the table, it can be seen that the outer loading value of all indicators has a value of > 0.70 . It can be stated that the indicator is valid to reflect measurement of Financial Distress. The level of reliability can be seen from value of Cronbach's alpha and composite reliability, which shows a value of > 0.70 . It can be said that all variable is reliable and each indicator has different construct reliability. Furthermore, the level of convergence can be seen from the AVE values, which all show > 0.5 , so it can be concluded that all of these indicators meet the requirements for good convergence.

2) Discriminant Validity

Discriminant or discriminant validity is used by comparing the loading value on the intended construct with another construct, where the intended construct must have a higher value.

| | Discriminant Validity | | | | Conclusion |
|-----|-----------------------|-------|--------------|--------------|------------|
| | FD | ROA | CR | DER | |
| FD | | | | | Valid |
| ROA | 0,876 | | | | Valid |
| DER | 0,701 | 0,735 | 0,814 | | Valid |
| SC | 0,803 | 0,815 | 0,824 | 0,835 | Valid |

Source: Data Processing on SmartPLS, 2024

From the table above, it can be seen that the results of Return on Assets (ROA) indicator $>$ other indicators. In the next column, on the Debt to Equity Ratio (DER) indicators $<$ other indicators, while the Size Company (SC) indicators $>$ from DER indicators. It can be concluded that the four indicators have a affect on Financial Distress

3.2. Analysis Model Structural (Inner Model)

1) R-Square

It is an analysis used to show how much the dependent variable is influenced by the independent variable. Weak, moderate and strong are some of the categories contained in R-square, which shows how much the potential of independent variable to affects dependent variables. The R-square value of 0.25 is said to be weak, 0.50 can be said to be in the moderate category, and 0.75 can be said to be in the strong category.

Table 2. R-Square

| Return on Assets | R-Square (R ²) | R-Square Adjusted | Conclusion |
|------------------|----------------------------|-------------------|------------|
| | 0,554 | 0,542 | Valid |

^b. Source: Data Processing on SmartPLS, 2024

From the results R-square in the table above, it can be concluded that the effect of ROA, DER and Size Company as a moderate variable on Financial Distress has a value of 0,554 or 55,4%, where this value is included in the strong category. Meanwhile, the remaining 44,6% explained by factors outside the research.

2) Path Coefficients

It was done using the bootstrapping procedure to determine the correlation between variables. The test criteria are carried out when the t-statistic value > t-table (1.96) and the probability value < alpha (0.05) it is stated that there is a significant effect of exogenous variables on endogenous variables.

Table 3. Path Coefficients

| | Original Sample (O) | Sample Mean (M) | Standard Deviation (STDEO) | T Statistics (O/STDEVI) | P Values |
|---|---------------------|-----------------|----------------------------|-------------------------|----------|
| ROA (X1) -> Financial Distress (Y) | 0,442 | 0,209 | 0,118 | 3,540 | 0,049 |
| DER (X2) -> Financial Distress (Y) | 0,305 | 0,307 | 0,391 | 0,815 | 0,266 |
| Size Company (X3) -> Financial Distress (Y) | 0,145 | 0,148 | 0,204 | 1,335 | 0,326 |

^c. Source: Data Processing on SmartPLS, 2024

The test results can be seen in the table above, the first hypothesis indicate that ROA have significant effect on financial distress with t-statistics (3.540) and p-value (0,049 < 0.05). The second hypothesis indicate that DER did not have significant effect on financial distress with t-statistics (0,815) and p-value (0.266 > 0.05). The third hypothesis indicate that size company dit not have a significant influence on financial distress with t-statistics (1,335) and p-value (0.326 > 0.05)

Discussion

Effect of Return on Assets (ROA) on Financial Distress

Based on the results of data analysis, ROA has a significant effect on financial distress with p-value (0,049 < 0.05) in the manufacturing companies listed in IDX for 2019-2022 period. This means that the company is in a healthy financial condition and avoids the threat of financial distress. Companies that have a high ROA is able to generate profits that can be used to finance its operations or obligations. The company's ability to pay for its needs and obligations means that the company can avoid financial distress. The results of this study are in line with previous research conducted by Dirman (2020); Kurniasih et al., (2020) which shows that ROA are influential significant in predicting financial distress. A high return on assets indicates that the company is able to use the assets it owns to generate profit from the sales and investments made by the company, so that the management of company assets is more effective and efficient which can ultimately reduce the costs incurred by the company, so the company will obtain savings and gain sufficient funds to run the business.

Effect of Debt to Equity Ratio (DER) on Financial Distress

Based on the results of data analysis, DER did not have significant effect on financial distress with p-value (0,266 > 0.05) in the manufacturing companies listed in Indonesia Stock Exchange for 2019-2022 period. This is because the manufacturing companies assets obtained through company debt to not have a sufficient role in influencing the level of financial distress experienced by a company. In addition, manufacturing sector companies generally will using long term debt to finance or acquire assets, so this clearly has no effect because using long term debt as finance tools are general activities in manufacturing business sectors. When the expenses incurred greater than the income earned as well as long term debt activities to acquire assets but ultimately assets does not

generate revenue for the company, it will provide very bad impact on the company's financial condition and vice versa. The results of this study are in line with previous research conducted by Edi & Eilyn (2023); Hananiyah & Jaya (2023), the debt to equity ratio does not significantly influence financial distress.

Effect of Size Company on Financial Distress

Based on the results of data analysis, Size Company did not have significant effect on financial distress with p-value ($0,326 > 0.05$) in the manufacturing companies listed in Indonesia Stock Exchange for 2019-2022 period. This is because a mature company, even though the company size is small, the company has many working partners, the level of trust from financial institutions in the company is high, as well as recommendations from clients and external parties. Any reduction or increase in company size will not affect the company experiencing financial distress. The greater the company's size, the higher the company's ability to generate profits, thereby reducing the company's dependence on financing its company's operations on loans, which can reduce financial distress. The results of this study are in line with previous research conducted by Christella & Osesoga (2019); Nurdiansari, (2023), the size company does not significantly influence financial distress

4. Conclusion

Based on the research results and discussions that have been presented, it can be concluded that ROA has a significant effect on financial distress. Meanwhile, DER, Company size, has no effect on financial distress in manufacturing companies for the period 2019-2022. This study contributes to manufacturing companies so that they can carry out effective, DER, Company size, so that their performance can improve financial performance. Based on the conclusions above, the implications of the results of this study for manufacturing company management can be an indicator of corrective actions before the company experiences financial distress or has the potential to go bankrupt. In addition, for the government so that it can be used as a consideration in determining financial policies for manufacturing companies.

Furthermore, it can be used as a consideration for investors in making decisions when investing. Therefore, this study provides benefits for manufacturing companies by providing information on the company's financial position in the safe, gray, or distressed zone. This study has several limitations; namely it is only limited to the manufacturing sector in Indonesia, where further research is recommended to expand the industrial sector as a research sample. Further research is recommended to analyze other factors that influence companies in predicting financial difficulties.

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