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The Effect of Leverage, Operating Capacity, and Sales Growth on Financial Distress with Corporate Governance as Moderating Variable

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Keywords:

Financial ratio, leverage, operating capacity, sales growth, corporate governance

Abstract

This study focuses on examining the interplay of Corporate Governance in the context of financial ratios, including Leverage, Operating Capacity, and Sales Growth, concerning Financial Distress. The theoretical frameworks guiding this research are the pecking order theory and agency theory. To gather data, the study employs a secondary data collection method through documentary analysis. The primary data source consists of the annual reports of manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2018 to 2020. The sample selection process adopts the purposive sampling method, resulting in a dataset comprising 194 data points. The findings of this research reveal that Leverage exerts a significant and positive influence on Financial Distress. Conversely, Operating Capacity and Sales Growth do not exhibit any significant effects on Financial Distress. Furthermore, the Moderating Regression Analysis (MRA) conducted indicates that Corporate Governance can moderate the relationship between Leverage and Operating Capacity concerning Financial Distress. However, Corporate Governance does not have a moderating effect on the relationship between Sales Growth and Financial Distress. These results shed light on the intricate dynamics between financial ratios, Corporate Governance, and Financial Distress, offering valuable insights for practitioners and policymakers in managing and assessing the financial health of manufacturing companies in the stock exchange.

1. INTRODUCTION

Companies operating in various business sectors in the business world inevitably experience both periods of success and challenges. They encounter not only opportunities and advantages but also threats and losses. Companies that continuously experience losses are at risk of facing financial distress, which can ultimately lead to bankruptcy if preventive measures are not taken. As reported by IDXChannel.com (2021), numerous large companies have filed for bankruptcy due to financial distress resulting from substantial debts and the necessity to cease operations during the Covid-19 pandemic.

This wave of bankruptcies has affected various business sectors, including restaurants, retail clothing and home equipment, oil manufacturers, and airlines. The situation has become even more critical when compared to the peak of financial distress that occurred in 2009, as the number of companies filing for bankruptcy has increased significantly. This phenomenon highlights that many companies are grappling with financial distress, primarily due to the sizeable debts they incurred, ultimately leading to bankruptcy. One of the key triggers for financial distress is a high level of leverage (Giarto & Fachrurrozie, 2020). Leverage is employed to assess the magnitude of debt used for a company's expenditures and to determine the proportion of capital and debt as sources of funds (Asfali, 2019).

An increase in leverage ratios corresponds to an elevated risk that a company may be unable to repay its debts, thereby heightening the likelihood of financial distress (Giarto & Fachrurrozie, 2020). Another factor that can precipitate financial distress is a low level of operating capacity (Fatmawati & Wahidahwati, 2017). Operating capacity is a ratio used to evaluate a company's ability to generate sales by optimally utilizing its assets (Handayani et al., 2019). Companies must be adept at maximizing the use of their owned assets. If assets are not utilized to their fullest potential, the company's income potential remains unrealized. Such circumstances significantly elevate the likelihood of the company

experiencing financial distress (Mafiroh & Triyono, 2016).

Another factor that can trigger financial distress is a low level of sales growth (Juhaeriah et al., 2021). Sales growth is a ratio used to measure and indicate the company's progress in terms of sales development (Saputra & Salim, 2020). Company agents need to make informed decisions regarding sales improvement strategies. If errors occur in selecting sales improvement strategies, the company's sales growth may decrease due to reduced sales generation, thereby increasing the risk of financial distress (Prasetya & Oktavianna, 2021). Financial distress can be mitigated by corporate governance, as it has the capacity to reduce agency problems and diminish information asymmetry levels (Ariesta & Chariri, 2013). The concept of corporate governance in Indonesia gained prominence during the financial crisis of 1997 to 1998 when the rupiah's value plummeted by nearly 80%. This drastic depreciation was attributed to the weak application of corporate governance by companies (IFC, 2014). Corporate governance encompasses the relationships between a company's management, board, stockholders, and other stakeholders with an interest in the company's operations (Prihanto, 2018). This study aligns with research conducted by Giarto & Fachrurrozie (2020). The researchers opted to use leverage, operating capacity, and sales growth as independent variables, as these ratios can significantly contribute to the occurrence of financial distress. Moreover, corporate governance is seen as a means to minimize the risk of financial distress. Hence, corporate governance is employed as a moderating variable to assess its potential to strengthen or weaken the influence of independent variables on dependent variables. Research on the theme of financial distress in Indonesian companies is not entirely new. Nevertheless, studies examining how financial distress is influenced by various factors such as leverage, operating capacity, and sales growth with the moderation of corporate governance are somewhat limited. This research also utilizes more recent data, covering the period from 2018 to 2020. In addition to addressing this research gap, the mixed results obtained in previous studies and the utilization of up-to-date data render these factors intriguing for further analysis.

2. LITERATURE REVIEW

2.1 Pecking Order Theory

Donaldson introduced the pecking order theory in 1961, and it was later given its name by Myers in 1984 (Riswan and Sari, 2015). The pecking order theory elucidates that companies give precedence to internal funding over external funding (Cotei et al., 2011). According to this theory, companies tend to favor the utilization of internal funding, which comprises retained earnings resulting from the company's operations (Wikartika & Fitriyah, 2018)

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2.2 Agency Theory

Jensen & Meckling (1976) in their research stated that agency theory explains that the interests of the principal and agent often conflict, leading to conflicts. This conflict arises because managers attempt to prioritize their personal interests, resulting in increased company costs and reduced profits. It is the disparity in interests between agents and principals that triggers agency conflicts (Putri, 2016).

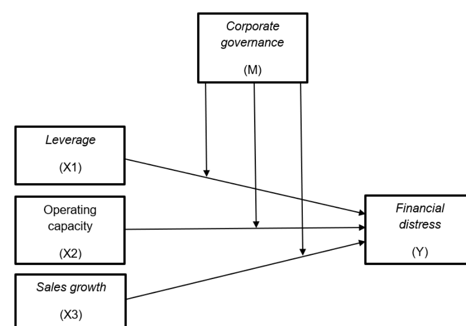

Figure 1
Frameworks Thinking theoretical

Based on framework thinking theoretical above , then _ hypothesis study This are :

H 1 : Leverage has a positive and significant effect on financial distress

H 2 : Operating capacity has a negative and significant effect on financial distress

H_3 : Sales growth has a negative and significant effect on financial distress

H_4 : Corporate governance is able to moderate the relationship between leverage and financial distress

H_5 : Corporate governance is able to moderate the relationship between operating capacity and financial distress

H_6 : Corporate governance is able to moderate the relationship between sales growth and financial distress

3. RESEARCH METHODS

3.1 Data Types and Sources

The type of data used in this study is documentary data from manufacturing companies listed on the Indonesia Stock Exchange (IDX) that issued annual reports during the period from 2018 to 2021. The data sources used in this study are secondary data. Secondary data is data that is not directly provided to the data collector but serves as a supportive source for primary data requirements (Sugiyono, 2017). This study obtained secondary data from the official website of the Indonesia Stock Exchange, which is www.idx.co.id.

3.2 Definitions Operations and Measurement Variables

1) financial distress

Rudianto (2013) stated that the Altman Z-Score can counted with formula US following :

$$Z = 1{,}2X_1 + 1{,}4X_2 + 3{,}3X_3 + 0{,}6X_4 + 1{,}0X_5$$

Description :

Ratio X_1 = Working Capital : Total Assets
Ratio X_2 = Profit Held : Total Assets
Ratio X_3 = EBIT : Total Assets
Ratio X_4 = Value of Shares: Total Debt
Ratio X_5 = Sales : Total Assets

2) Corporate Governance

Researchers measure corporate governance using the ASEAN Corporate Governance Scorecard (ACGS), which is one of the good corporate governance scorecards used in the Southeast Asia region (Ramli & Setiany, 2021). The ASEAN Corporate governance Scorecard (ACGS) is one of the latest corporate governance assessment designs presented by the ASEAN Capital Market Forum (ACMF) as an instrument for ranking the performance of public corporate governance in ASEAN (Sulastri et al, 2018).

$$\text{ACGS} = \frac{\text{Total Number Scored by PLC}}{\text{Total Number of Questions}} \times \text{Maximum Attainable Score}$$

3) Leverage

According to Cashmere (2019), leverage can counted with formula US following :

$$\text{Debt to Equity Ratio} = \frac{\text{Total Utang}}{\text{Ekuitas}}$$

4) operating capacity

According to Rahmy (2015), operating capacity can counted with formula US following:

$$\text{Total Asset Turn Over} = \frac{\text{Penjualan Bersih}}{\text{Total Aset}}$$

5) Sales Growth

According to Putri & Kristanti (2020), sales growth can counted with formula US following :

$$\text{Sales Growth} = \frac{(\text{Penjualan}_t - \text{Penjualan}_{t-1})}{\text{Penjualan}_{t-1}}$$

3.3 Methods Analysis

Method analysis used _ in study This is with use analysis regression moderation . The formula are :

$$FD = a + b_1 L + b_2 OC + b_3 SG + b_4 CG + b_5 L.CG + b_6 OC.CG + b_7 SG.CG + e$$

Description :

FD = Financial Distress
α = Constant
β = Coefficient Regression
L = Leverage
OC = Operating Capacity
SG = Sales Growth
CG = Corporate Governance
e = error

4. RESULTS AND DISCUSSION

4.1 Research results

a. Simultaneous Test Results (Test F)

F statistic test was performed For know is variables independent in a manner together (

simultaneously) affect variables dependent or no (Ghozali , 2016).

Table 4.1.1
Statistical Test Results F

Variabel	F	Sig.
Hubungan *Leverage, Operating Capacity, Sales Growth, Financial Distress,* dan *Corporate Governance*	82,774	0,000

Source : Data processed (2023)

Based on Table 4.1.1, results testing shows mark significance of the F statistical test of 0,000. Test results the prove that exists influence leverage, operating capacity, sales growth, financial distress, and corporate governance as variables moderation .

4.1.2 Coefficient Test Results Determination (R^2)

Research model capabilities in explain variations variables independent can be measured use coefficient determination (R^2) (Ghozali , 2018).

Table 4.1.2
Coefficient Test Determination (R^2)

Variabel	R^2	Adjusted R^2
Hubungan *Leverage, Operating Capacity, Sales Growth, Financial Distress*, dan *Corporate Governance*	0,757	0,748

(Source : Data processed 2023)

Based on Table 4.2, financial distress explained by leverage, operating capacity , and sales growth which is moderated by corporate governance , by 74.8%. However the rest 25.2 % is explained by other outside variables from research models this .

4.1.3 Partial Test Results (t test)

Influence individually between _ One variables independent to variables dependent can is known with perform a t statistical test or also called a partial test (Ghozali , 2016).

Table 4.1.3
T Statistical Test Results

Variabel	Koefisien Regresi	Sig.	Keterangan
Leverage	0,801	0,000	Signifikan
Operating Capacity	-0,020	0,850	Tidak signifikan
Sales Growth	-0.059	0,494	Tidak signifikan
Corporate Governance	0,192	0,000	Signifikan
SQRT_L_CG	-1,349	0,000	Signifikan
SQRT_OC_CG	0,609	0,000	Signifikan
SQRT_SG_CG	0,092	0,287	Tidak signifikan

(Source : Data processed 2023)

4.2 Research Discussion

1) The Effect of Leverage on Financial Distress

Based on the results of the research, it was found that leverage has a positive and significant impact on financial distress. This indicates that an increase in leverage is followed by an increased risk of financial distress. The results of this research support Hypothesis H1. High leverage can threaten a company's financial health because it can push the company into extreme levels of debt, making it difficult to free itself from the burden of debt (Fahmi, 2014). Companies with high leverage

may also face challenges in obtaining loans, as it can influence creditors' decisions to lend funds, ultimately affecting the company's profitability (Susilowati & Fadlillah, 2019). This study aligns with the findings of previous research conducted by Candradewi & Rahyuda (2021), which also found a positive and significant relationship between leverage and financial distress. Similarly, the study is consistent with the research conducted by Giarto & Fachrurrozie (2020), which reported a positive and significant impact of leverage on financial distress.

2) Influence of Operating Capacity to Financial Distress

Based on the research results, it was found that operating capacity has a negative but not significant effect on financial distress. This suggests that operating capacity does not exert a strong influence on increasing the risk of financial distress. The results of this research do not support Hypothesis H2. A decrease in sales volume does not directly cause a company to experience financial distress but can lead to a decrease in the company's profits. If the decline in sales remains within reasonable limits determined by the company, it may not significantly influence financial distress (Liana & Sutrisno, 2014). This study aligns with the findings of previous research conducted by Idawati (2020), which also reported a negative and nonsignificant relationship between operating capacity and financial distress. Similarly, the study is consistent with the research conducted by Rahmy (2015), which found that operating capacity has a negative and nonsignificant impact on financial distress.

3) Effect of Sales Growth to Financial Distress

Based on the research results, it was found that sales growth has a negative but not significant influence on financial distress. This suggests that sales growth does not exert a strong influence on increasing the risk of financial distress. The results of this research do not support Hypothesis H3. Low sales growth does not significantly contribute to the risk of financial distress. A company with consistently low sales growth may pose a higher risk of financial distress if this trend continues over a certain period. Sales for a company can experience fluctuations from year to year (Novyarni & Dewi, 2020). This study aligns with the findings of previous research conducted by Rahmy (2015), which reported a negative and nonsignificant relationship between sales growth and financial distress. Similarly, the study is consistent with research conducted by Suryani (2020), which found that sales growth has a negative and nonsignificant impact on financial distress.

4) Influence Leverage to Financial Distress and Corporate Governance as Variables Moderation

Based on the research results, it was found that corporate governance can moderate the relationship between leverage and financial distress. This indicates that companies with good corporate governance practices can weaken the link between leverage and financial distress. The results of this research support Hypothesis H4. Corporate governance plays a crucial role in controlling and determining a company's debt to prevent excessive borrowing (Handriani et al., 2021).

Effective implementation of corporate governance can help companies avoid financial distress and bankruptcy (Udin et al., 2016). Companies must carefully assess their sources of financing and choose the most cost-effective funding options. The decision regarding the sources of company funds should be made wisely to prevent the company from taking on excessive debt and incurring high costs, which can help mitigate the risk of financial distress. This study is consistent with the findings of previous research conducted by Giarto & Fachrurrozie (2020), which demonstrated that corporate governance, proxied by managerial ownership, can moderate the relationship between leverage and financial distress.

5) Influence Operating Capacity to Financial Distress and Corporate Governance as Variables Moderation

Based on the research results, it was found that corporate governance can moderate the relationship between operating capacity and financial distress. This indicates that companies with strong corporate governance practices can strengthen the link between operating capacity and financial distress. The results of this research support Hypothesis H5. In line with agency theory, which emphasizes that agents bear full responsibility for managing a company's assets, improving managerial performance in asset management and sales production can lead to increased profits for the company.

This, in turn, can contribute to better financial health for the company and reduce the likelihood of financial distress (Larasati & Wahyudin, 2019). Companies with effective corporate governance practices tend to operate efficiently in their day-to-day activities. This means that their management is skilled at maximizing the use of assets to increase sales and generate more significant profits. As a result, these companies are better equipped to avoid financial distress. This study is consistent with previous research conducted by Larasati & Wahyudin (2019), which found that corporate governance, proxied by managerial ownership, can moderate the relationship between operating capacity and financial distress.

6) Influence Sales Growth to Financial Distress and Corporate Governance as Variables Moderation

Based on the research results, it was found that corporate governance cannot moderate the relationship between sales growth and financial distress. This indicates that companies with strong corporate governance practices do not necessarily strengthen the link between sales growth and financial distress. The results of this research reject Hypothesis H6. The test results indicate that corporate governance is unable to strengthen the relationship between sales growth and financial distress. This could be attributed to two main factors. First, there are frequent conflicts between managers and shareholders.

Managers may prioritize their personal well-being over efforts to improve the company's management. Second, there is weak control over management. Proper supervision is not consistently implemented by institutional parties according to established procedures, resulting in weak management oversight (Komala & Triyani, 2019). Therefore, it is essential for companies to enhance their management practices and tighten supervision to ensure that management activities operate optimally and effectively, reducing the risk of financial distress. This study aligns with previous research conducted by Komala & Triyani (2019), which found that corporate governance, proxied by managerial ownership and institutional ownership, cannot moderate the relationship between sales growth and financial distress.

5. CLOSING

5.1 Conclusion

1. Leverage has a positive and significant influence on financial distress. Companies with high leverage are at an increased risk of experiencing financial distress due to the burden of high debt levels.
2. Operating capacity, on the other hand, has a negative but not significant influence on financial distress. Increasing operating capacity may lead to a higher financial burden, resulting in limited contributions to the company's financial well-being.
3. Sales growth also exhibits a negative and non-significant influence on financial distress. Sales growth alone cannot be used as a sole indicator to determine a company's financial distress since declining sales do not directly cause financial distress but can impact profits.
4. Corporate governance plays a crucial role in moderating the relationship between leverage and financial distress. Effective corporate governance can help prevent excessive borrowing and reduce the risk of financial distress.
5. Corporate governance positively and significantly influences the relationship between operating capacity and financial

distress. Companies with strong corporate governance practices can maximize asset utilization, leading to increased profits and reduced financial distress.

6. Corporate governance, however, does not significantly influence the relationship between sales growth and financial distress. This may be attributed to frequent conflicts between managers and shareholders and weak controls over management, leading to an inability to strengthen the connection between sales growth and financial distress.

5.2 Suggestions

This research aims to assist companies in detecting potential financial distress or bankruptcy by providing valuable references. The developed tools serve as essential resources for identifying signs of financial distress within a company and offer insights into its activities, aiding potential investors in making informed decisions. Nevertheless, this study has certain limitations that can guide future research. Firstly, it focused solely on manufacturing companies, limiting its scope. Expanding the study to include various sectors would provide a more comprehensive understanding.

Secondly, the analysis was based on three years of secondary data, potentially missing long-term trends. Extending the research period would enhance robustness. Additionally, the moderation interaction method led to multicollinearity issues, suggesting alternative moderation techniques for future studies. Lastly, the independent variables explained only 74.8% of the dependent variable's variance. Future research should explore additional independent variables to enhance accuracy. To advance future research, diversify sectors, extend the research period, employ alternative moderation methods, and include more independent variables for comprehensive insights.

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