**Original Research Article**

# Effect of Profitability, *Leverage*, Liquidity, Audit Committee on *Financial Distress*

Rona Tumiur Mauli Carolin Simorangkir[*]

Mercu Buana University Indonesia

## Abstract

The purpose of this study is to analyze the effects of Profitability, Leverage, and Liquidity on Financial Distress which is proxied using Z-scores. The object of research is the sub-sector of property and real estate companies listed on the Indonesia Stock Exchange in 2016-2018. This research was conducted using a sample of 47 companies listed on the Indonesia Stock Exchange. Determination of the sample using a purposive sampling method with criteria by researchers using a causal relationship design. The analysis of data use statistical analysis in the form of multiple linear regression tests. The result of this study is that profitability, and liquidity variables have significant effects and positive on financial distress. The Leverage variable has a significant effect and negative on financial distress. While The Audit Committee has no effect on financial distress.

**Keywords:** Profitability, Leverage, Liquidity and Financial distress.

## INTRODUCTION

Financial statements are a structured presentation of a company's financial position and financial performance. The purpose of financial statements is to provide information about a financial position, financial performance, and cash flow of the entity useful for some users of financial statements in making decisions. From the financial statements can also show results for accountability for the use of resources that are trusted to the company. The company was founded with the aim of obtaining profits through the business that it runs, in running and falling business is a normal thing that happens by a company. When a company experiences financial difficulties, it becomes a consideration for investors or creditors who will invest their capital. That way a company should be able to show the company's good performance in order to get an injection of funds for the sustainability of the business being run.

According to Fahmi [1], *financial distress* is a condition in which a company experiences financial difficulties before bankruptcy or liquidation. The *financial distress* model needs to be developed, because by knowing the company's condition early on, it is expected that actions can be taken to anticipate financial conditions that lead to financial difficulties leading to bankruptcy. *Financial distress* or company financial problems can be caused by several reasons, such as companies experiencing continuous loss, declining sales, natural disasters that make a company's assets damaged, and can also be caused by an unstable economic condition of a country that triggers a financial crisis to the company.

Profitability is a ratio to assess a company's ability to look for profits or profits in a certain period. The greater the ratio that is produced, the better the company in generating profits for the company so that it is more protected from *financial distress* Kashmir [2]. Ayu, *et al*. [3] conducted a study that resulted in profitability and a significant negative effect on *financial distress*. While the research conducted by Yustika [4] obtained profitability results that had a positive effect on *financial distress*. *Leverage* is a ratio used to measure the extent to which a company's assets are financed by debt, the amount of debt used by the company to finance its business activities compared to its own capital [2]. Research conducted by Widhiari and Merkusiwati [5] results in *leverage having* no effect on *financial distress*. While research conducted by Kusuma and Sumani [6] results in that *leverage* has a significant and positive effect on *financial distress*. According to Kusuma and Sumani [6] liquidity shows the ability of an entity to cover the company's current liabilities by utilizing its current assets. A liquid

company usually usually has a good performance and will prevent the company from the possibility of *financial distress*. Nugroho [7] conducted a study that produced liquidity that had no effect on *financial distress*. While research conducted by Yustika [4] produces liquidity has an influence on *financial distress*.

## REVIEW OF LITERATURE AND HYPOTHESES

Agency Theory is a theory that explains the conflicts that occur with the company management as an agent with the company owner as the principal. An agency relationship is defined by Jensen and Meckling [8] as a contract between one or more people (principals) who bind another person (agent) to do something on behalf of the principal relating to the delegation of decision-making authority to the agent. In today's economy, management and management of companies are increasingly separated from company ownership. This is in line with Agency Theory which emphasizes the importance of company owners (shareholders) providing company management to *professionals* who understand more in running the company on a daily basis. The purpose of separating management from company ownership is so that the owner of the company gets the maximum benefit at the most cost-efficient cost as possible by the management of *professionals.*

*Financial Distress* is a condition where a company's finances are in an unhealthy state or crisis. *Financial distress* has a close relationship with bankruptcy in a company, because *financial distress* is the stage where the company's financial condition decreases before bankruptcy. *Financial distress* or financial difficulties should be sought to be avoided by all companies, because it can have the worst consequences that could result in a company being declared bankrupt and unable to run a business anymore. *Financial distress* can be seen when a company has difficulty in fulfilling its obligations to pay its debts to creditors when they are due [4]. *Financial distress is* influenced by various factors both from internal or external companies. Internal factors that influence *financial distress* are cash flow difficulties, the amount of the company's debt, and losses experienced by the company in operational activities for several years. While external factors that influence *financial distress* are more macroeconomic in nature and can have direct or indirect effects, such as an increase in loan interest rates and also natural disasters [3]. Analysis of the Altman *Z-score* model is an analysis designed to find out predicting financial statements, which is to reveal the strengths and weaknesses of a company to find out whether the financial position is improving or deteriorating for the sake of a company's sustainability, so the *z-score* analysis is more suitable for non-company operating scales. Banks [9]. The Altman model that fits into the *property* and *real estate* sub-sector is using

### Altman [10] as follows
$$Z = 6.56\ X_1 + 3.26\ X_2 + 6.72\ X_3 + 1.05\ X_4$$

### Profitability

Profitability is the end result of a number of policies and decisions made by the company. If the profitability of the company is good, the creditors, suppliers, and investors will see the extent to which the company can generate profits from the sale and investment of the company [11]. *Return on Equity* (ROE) is a measurement of earnings (*income*) available to the owners of the company (both common shareholders and preferred shareholders) on the capital they have invested in the company. In general, of course, the high *return* or income obtained by the good position of the company owner. *Return On Equity* or can be called ordinary equity return is a ratio used to measure how much return on ordinary equity. The formula used to find out this ratio is,

$$ReturnOnEquity(ROE) = \frac{Lababersih}{Ekuitas}$$

*Leverage* is a ratio used to measure the extent to which a company's assets are financed with debt, the amount of debt used by the company to finance its business activities compared to its own capital [2]. Companies that have more debt than equity are said to be companies with a high degree of *leverage. Leverage* can also be used to measure the ratio between total debt to total assets. The *leverage* ratio is also often referred to as the *debt to asset ratio* (*debt to asset ratio*). The *leverage* ratio describes the extent to which owner's capital can cover debts to outgoing parties. The smaller this ratio, the better, for the security of outsiders the best ratio if the amount of capital is greater than the amount of debt or at least the same. But for shareholders or management this ratio should be large.

$$Debt\ to\ Aset\ Ratio(DebtRatio) = \frac{TotalHutang}{TotalAktiva}$$

In other words, *debt ratio* is one type of *leverege* ratio that measures the amount of company assets financed by debt or capital from creditors. If the ratio calculation results are high then the risk level is also high.

### Liquidity

This ratio shows the ability of an entity to cover the company's current liabilities by utilizing its current assets. A liquid company usually has good performance and will avoid the company from possible *financial distress*. Liquidity ratios are ratios that illustrate a company's ability to meet its short-term obligations that are due soon [6].

$$CurrentRatio(CR) = \frac{AsetLancar}{KewajibanLancar}$$

## HYPOTHESIS DEVELOPMENT
**Effect of Profitability on *Financial Distress***

In the agency theory, it is explained that there are differences in interests between management and company owners that are prone to conflict. If a company has high profits, management as an agent must also provide social and environmental activities as an embodiment of social contracts that occur in interaction with the community. From the conclusions above, researchers have the opinion that high profitability makes the company experience less *financial distress.* Yustika's research [4] shows that profitability has an influence on *financial distress.* This shows the high profitability of a company is able to generate high profits, so that the increase in assets will also occur and will keep the company from the threat of *financial distress.*

**H $_1$: Profitability affects the *financial distress***

**Effect of *Leverage* on *Financial Distress***

*Leverage* is a ratio used to measure the extent to which a company's assets are financed with debt, the amount of debt used by the company to finance its business activities compared to its own capital [2]. *Financial distress* can be known from the inability of the company to fulfill its obligations, both short-term obligations included in the liquidity category and also included in the solvency category. This is in accordance with research Andre and Taqwa [12] shows that *leverage* has a significant effect on *financial distress.* This shows that the greater the amount of debt compared to company assets, the higher the probability of the company experiencing *financial distress.*

**H $_2$: *Leverage* affects *Financial Distress***

**Effect of Liquidity on Financial *Distress***

Liquidity shows the ability of an entity to cover the company's current liabilities by utilizing its current assets. Liquid companies usually have good performance and will avoid the possibility of *financial distress*. High cash and accounts receivable describe the company making high sales, which means high sales can cover existing expenses and can also pay off short-term debt owned [6]. Yustika's research results [4] show that liquidity has an influence on *financial distress*. This shows that the lower the liquidity, the more likely the company is experiencing *financial distress,* because the company is unable to meet its short-term debt.

## RESEARCH METHODS
**Variable Definition and Operations**
**Dependent Variable**

*Financial Distress*

To measure *financial distress* using the Altman *Z-score*. The Altaman model is as follows: $Z = 6.56 X_1 + 3.26 X_2 + 6.72 X_3 + 1.05 X_4$

**Independent Variable**
a) Profitability

Profitability is a ratio to assess a company's ability to seek profits or profits in a certain period [2].

$$Return\ On\ Equity = \frac{Net\ Income}{Total\ Equity}$$

*b) Leverage*

*Leverage* is a ratio used to measure the extent to which a company's assets are financed with debt, the amount of debt used by the company to finance its business activities compared to its own capital [2].

$$Debt\ to\ Asset\ Ratio = \frac{Total\ Liabilites}{Toal\ Asset}$$

c) Liquidity

Liquidity ratios are ratios that illustrate a company's ability to meet its short-term obligations that are due soon.

$$Current\ Ratio = \frac{Current\ Asset}{Current\ liabilities}$$

**Population and Sample**

The population of this sample is the building construction sub-sector company which is listed on the Indonesia Stock Exchange (IDX). The sample is a portion of data taken from the population using certain methods. Sampling in this study by purposive sampling, namely data source sampling techniques with certain considerations [13], the criteria in taking these samples are:

1. *Property* and *real estate* sub- sector companies listed on the Indonesia Stock Exchange in the period 2016 to 2018.
2. *Property* and *real estate* sub- sector companies listed on the Indonesia Stock Exchange which publishes *annual reports for the* period of 2016 to 2018.
3. *Property* and *real estate* sub- sector companies listed on the Indonesia Stock Exchange that suffered losses in the period of 2016 to 2018.

**Table-4.7: Sample Selection Criteria**

| NO | Information | total |
|---|---|---|
| 1 | Number of *property* and *real estate* sub-sector companies listed on the Indonesia Stock Exchange in 2018 | 59 |
| 2 | *Property* and *real estate* sub-sector companies delesting from the IDX in 2016 to 2018 | (3) |
| 3 | New *property* and *real estate* sub *sector* companies were listed on the Indonesia Stock Exchange during the period of 2016 to 2018 | (9) |
| 4 | Number of Samples | 47 |
| 5 | Research Year | 3 |
| 6 | Total research sample data for 2016 to 2018 | 141 |

**Source:** which has been processed?

# DATA ANALYSIS METHOD

### a) Descriptive Statistics Analysis

Descriptive analysis provides a description or description of the data seen from the mean ( *mean* ), standard deviation, variance, maximum, minimum, *sum, range, kurtosis* , and *skeness* (skewed distribution) [1]. Descriptive statistics are used by research to provide information about the characteristics of variables. The purpose of descriptive statistical analysis in this study was to determine the profitability, *leverage*, and liquidity of *financial distress.*

### b) Classical Assumption Test Analysis

The classic assumption test aims to ensure that the data generated are normal distribution. The classic assumption tests used are the Normality Test, the Multicolonierity Test, the Heteroscedasticity Test and the Autocorrelation Test.

### c) Test Determinant coefficient ($R^2$)

Test determinant coefficient ($R^2$) was conducted to determine how much interest or closeness of variables, between the dependent variable and independent variables.

### d) Simultaneous Significance Test (Statistical Test F)

This test basically shows whether all independent variables in the regression model have a joint influence on the dependent variable [1]. For the purpose of decision making, a *significance* level of 0.05 (5%) is used.

### e) Individual Parameter Significance Test (Statistical Test t)

This test basically shows how far the influence of one independent variable individually in explaining the variation of the dependent variable. The test was carried out using a significance level of 0.05 ( $\alpha$ = 5%) [1].

### f) Multiple Linear Regression Analysis

Multiple linear regressions are a measure of the effect between the dependent variable and the dependent variable (Y) with two or more independent variables (X). So that a variable can be predicted from other variables. The form of the equation in this study is:

$$FD = a + \beta1\ ROE + \beta2\ DAR + \beta3\ CR + \beta4\ KA + e$$

**Information**
FD = *Financial Distress*
ROE = Return on equity
DAR = Debt to assets ratio
CR = *Current Ratio*
KA = Audit Committee
$a$ = Constant
$\beta$ 1−5 = Regression Coefficient
$e$ = Error

# RESULTS AND TRANSLATIONS

### The coefficient of determination results

The results of the determinant coefficient test in table 4.7 above can be seen that the *R Square* value of 0.408 shows that the variation of financial distress can be explained by variations in profitability, leverage, liquidity of 40.8%. While the remaining 59.2% (100% - 40.8%) is influenced by other factors not examined.

**Tatistical Test F**

**Table-4.8**: **Simultaneous Significance Test Results (Test F)**

| ANOVA [a] | | | | | | |
|---|---|---|---|---|---|---|
| Model | | Sum of Squares | df | Mean Square | F | Sig. |
| 1 | Regression | 293,666 | 4 | 73,416 | 18,111 | .000 [b] |
| | Residual | 381,040 | 94 | 4,054 | | |
| | Total | 674,706 | 98 | | | |
| a. Dependent Variable: Y | | | | | | |
| b. Predictors: (Constant), x4, X1, X3, X2 | | | | | | |

Based on the Simultaneous Significance test (Test F) in table 4.8 above it is known that the F value of 24.578 with a probability of 0.000 <0.05, this means that the model is feasible to be used in this study. So it can be concluded that profitability, *leverage,* liquidity simultaneously significantly affect *financial distress.*

**Table-4.9: Significance Test Results for Individual Parameters (Statistical Test t)**

| Coefficients a | | | | | | |
|---|---|---|---|---|---|---|
| **Model** | | **Unstandardized Coefficients** | | **Standardized Coefficients** | **t** | **Sig.** |
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | 3,833 | 709 | | 5,405 | .000 |
| | X1 | 13,247 | 2,693 | .383 | 4,918 | .000 |
| | X2 | -3,921 | 1,323 | -.266 | -2,964 | .004 |
| | X3 | .462 | 109 | .358 | 4,246 | .000 |
| | x4 | -241 | 279 | -.072 | -.864 | .390 |
| a. Dependent Variable: Y | | | | | | |

*The data source isprocessed by SPSS20*

Based on the results of the t test in table 4.9 above we can get the multiple linear regression equation as follows:

FD = 3,833+ 13,247 ROE - 3,921 DAR + 0,462 CR - 0,241 KA + *e*

**Effect of Profitability on *Financial Distress***

The first hypothesis states that there is an effect of profitability on *financial distress*. The results showed that 0.000 was obtained which was smaller than the significance of 0.05 (sig 0,000 <0.05) so that proving profitability had a significant positive effect on *financial distress.* These shows that every 1% increase in ROE will also increase the company avoid *financial distress* of 13,247 (13,247%). That if the percentage of profitability is high, it can be interpreted that the greater the company will avoid *financial distress.* If the level of profitability is high, it will attract investors to invest their capital because they have good company value and make the company avoid *financial distress.*

The results of this study are in line with that conducted by Listyorini wahyu widati [14] using the *Return on Equity* (ROE) proxy which states that profitability has a significant positive effect on *financial distress.*

**Effect of *Leverage* against *Financial Distress***

The Second Hypothesis states that there is an influence of *leverage* on *financial distress.* Hypothesis research results obtained by 0.004 which is smaller than the significance of 0.05 (0.004 <0.05), thus proving that *leverage* has a significant negative effect on *financial distress.* Leverage regression coefficient of -3.921, this shows that every 1% increase in leverage will cause a decrease in *financial distress* by the coefficient and vice versa.

The results showed that the *leverage* variable with a *debt ratio* proxy had a negative effect on *financial distress.* That is, a lot of the company's assets financed by debt. The use of debt that is too high will endanger the condition of a company. When a company has a lot of debt to be used as capital, it is feared that the obligations borne by the company have a high value, resulting in a high *leverage* ratio. So with a negative *leverage* value, it means that the amount of debt accumulated against the company's capital is greater and is prone to meeting its long-term obligations. It could be said also in sub-sectors of the *property and real es tate* more to finance its operations by using capital obtained from third parties in the form of debt. A large company tends to rely mostly on financing on *bank* loans. It can be concluded that the use of debt in this sector affects *financial distress.* If a company does not use its assets that are financed with debt optimally and on target, it causes the company to suffer losses. Art Inya if companies manage debt properly make the company can avoid the occurrence of *financial distress.*

This study is in line with research conducted by Sakinah [15] which uses a *debt to ratio* (DAR) proxy with the results of *leverage having a* negative effect on *financial distress.*

**Effect of Liquidity on *Financial Distress***

The third hypothesis states that there is an influence of liquidity on *financial distress.* The results showed a value of 0,000 which was smaller than 0.05 (sig 0,000 <0.05), this proves that every 1% increase in the *current ratio* then there was an increase in *financial distress* by 0.462 (0.462%) which means that the company is more likely to meet obligations the short term by relying on current assets. This proves that liquidity has a significant positive effect on *financial distress.*

Liquidity ratios in a company should be one of the pillars of the company in order to survive in the face of the possibility of *financial distress.* Liquidity difficulties can be caused by the company's failure to collect receivables from customers or other parties. The impact of the failure of collection of receivables is what causes the company does not have sufficient funds to

pay for its obligations and operational needs of the company.

The results of this study are consistent with the results of research conducted by Kusuma and Sumani [6], as well as Yudiawati and Indriani [16], which prove that liquidity has a positive influence on *financial distress.* Similar with Anggraini [17], Current Ratio has positive influence on Financial Distress.

### Effect of audit committee on financial distress

The Audit Committee has a significance probability of 0.864. This shows that the probability of significance is greater than the significance level α = 0.05 (0, 394 > 0.05). So this partially variable Audit Committee has no influence on *financial distress.*

This means that the audit committee as measured by the intensity of the audit committee meeting cannot reflect the company in the healthy category, because in the audit committee meeting is not only intended to discuss *financial distress* but the survival of the company.

The results of this study are consistent with the results of Damayanti [18] research which proves that the Audit Committee has no effect on *Financial Distress.* This proves the results of this study are consistent that the Audit Committee has no influence on *Financial Distress.*

The occurrence of *financial distress.* Liquidity difficulties can be caused by the company's failure to collect receivables from customers or other parties. The impact of the failure of the collection of receivables is what causes the company does not have sufficient funds to pay for its obligations and operational needs of the company. The results of this study are consistent with the results of research conducted by Kusuma and Sumani [6], as well as Yudiawati and Indriani [16], which proves that liquidity positive effect on *financial distress.*

## CONCLUSION

From the results of research conducted by the author, the following conclusions can be drawn:
1. Profitability that uses the *Return On Equity* (ROE) proxy has a positive effect on *financial distress* and this ratio can predict the condition of *financial distress* in the *property* and *real estate* sub sector listed on the Indonesian stock exchange
2. *Leverage* using the *Debt to Asset Ratio* (DAR) proxy has a negative effect on *financial distress* in the *property* and *real estate* sub-sector.
3. Liquidity using the *current ratio* (CR) proxy has a positive effect on *financial distress* in the *property* and *real estate* sub-sector.

4. Audit committee has negative effect on financial distress in the property and real estate sub sector.

## SUGGESTION

Based on the results of the discussion and conclusion above, the writer tries to give the following advice
1. Academics can conduct research using other variables or add other variables as independent variables. Considering there are many other factors that can affect *financial distress.*
2. The company must pay more attention to the performance and ability of the company in managing their assets so as to avoid the possibility of *financial distress* or bankruptcy of the company. The company must also conduct a review of the company's debt in an effort to avoid the occurrence of a default moment, one of which is the cause of the potential *financial distress.*
3. For investors, the results of this study can be taken into consideration by observing the financial performance produced by the company. From these observations investors will get complete information so they can choose companies that have good performance so as not to lose in investing their capital in a company.
4. It is hoped that this research can provide an overview of accounting practices carried out in the business world, and can be additional information and references for further research on the topic under study. This research can add and increase knowledge and insight about accounting knowledge related to factors that can affect *financial distress.*

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