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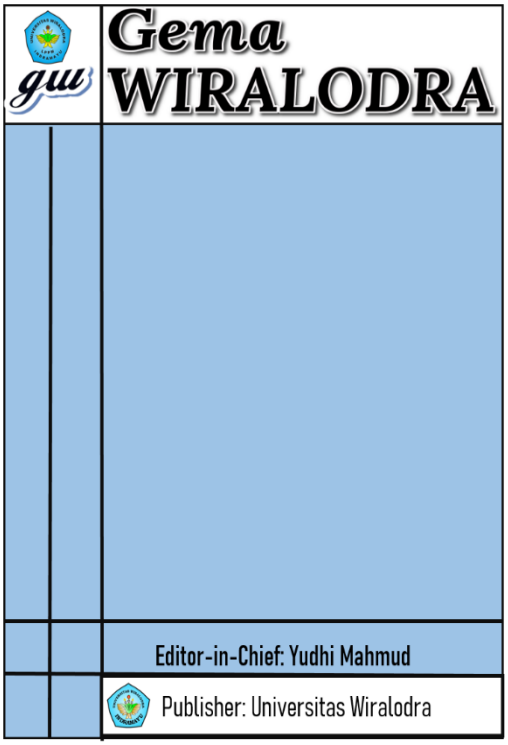


# Financial Distress, What Factors Affect It?

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# Financial Distress, What Factors Affect It?

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**Abstract**
Every company, small or large, can experience financial distress, to anticipate it, company need to know the factors that lead to financial distress. This study aimed to examine the relationship between operation cash flow, leverage, size of the company, retained earnings, director size, and audit committee on financial distress. This study used 114 manufacturing companies listed on the Indonesian stock market from the year 2018 until 2022. This research added director size and audit committee. The research uses quantitative data, and the data type used is secondary data collected from the financial reports of the companies under study listed on the Indonesia Stock Exchange. The result showed that operation cash flow, size of company, retained earnings, and director size have negative relationships with financial distress. However, leverage and audit committees have positive relationships. Management needs to manage operating cash flow, minimize leverage, manage the size of the company and retained earnings also manage the size of the director and audit committee according to the size of the company.
**Keywords:** Financial distress, operation cash flow, director, audit committee

## 1. Introduction

The spread of COVID-19, which began in early 2020, led to a global economic slowdown, including in Indonesia, as reported by the Ministry of Industry. Indonesia's GDP experienced a negative growth of 2.1% in 2020 but started to improve with a growth of 3.69% in 2021. The manufacturing sector, besides facing the ongoing pandemic, also encountered disruptions in the supply chain and container shortages. The economic downturn can trigger financial distress for companies. Financial distress begins with a decline in a company's finances before eventually leading to bankruptcy (Bernardin & Tifani, 2019). The initial signs include difficulties in paying suppliers, employee salaries, and debt payments to banks. This can be assessed through financial ratios, such as profit, liquidity, and debt (Dirman, 2020).

Apart from financial ratios, predictions of financial difficulties can be derived from cash flow statements. Various studies have been conducted to predict financial distress, including Altman's Z-score model. The relationship between cash flow and financial distress has been extensively researched (Bui & Thach, 2023; Bernardin & Tifani, 2019; El-Ansary & Bassam, 2019; Phan et al., 2022). If a business experiences financial distress, it will face cash flow difficulties. A study by Phan et al. (2022) expanded the research beyond operating cash flow to include investment and financing cash flows, finding that higher operating and financing cash flows can help companies avoid financial distress, while higher investment cash flows can increase the likelihood of financial distress.

Companies often seek external funding through debt, and increasing debt leads to higher interest payments. Therefore, an increase in debt raises the likelihood of financial distress (Rafatnia et al., 2020; Bui & Thach, 2023; Bernardin & Tifani, 2019; Habib & Kayani, 2022; Indarti et al., 2020; Isayas, 2021). Larger companies have a greater chance of obtaining external funding compared to smaller ones. External funding can support business activities, reducing the risk of financial distress for larger companies (Bui & Thach, 2023; Dirman, 2020; Isayas, 2021; Truong & Nguyen, 2022). Companies that can internally finance their needs reduce the reliance on external funding, especially from debt. Internal financing, such

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as retained earnings, helps companies avoid debt interest and reduces the likelihood of financial distress (Bui & Thach, 2023; El-Ansary & Bassam, 2019).

The cash flow statement depicts the cash and cash equivalents along with cash inflows and outflows over a specific period, usually one year (Bernardin & Tifani, 2019). It provides information on the company's operational, investment, and financing activities. Operating cash flow is crucial for investors, creditors, and other stakeholders as it involves the most liquid assets in a company: cash and cash equivalents.

Companies often fund their operational and investment activities through debt, especially those in the development or expansion stage, which generally requires significant funding. Companies should carefully determine the amount of debt and sources for debt repayment (Bernardin & Tifani, 2019). Companies should be cautious in using debt since high levels of debt often do not benefit the company. A significant debt composition lowers stakeholders' confidence in the company's value. Creditors pay attention to the company's debt ratio and assess debtor risk. A higher debt amount increases interest payments, raising the risk of the company being unable to pay interest and principal at maturity.

The measurement of a company's magnitude can be based on the total assets it possesses. The larger the total assets owned by a company, the bigger the indication of the company's size. Companies with large total assets send a positive signal to creditors that they can repay their debts. Small-sized companies will find it more challenging to obtain external funding compared to larger companies. Small-sized companies are also limited in terms of market recognition, connectivity, and funding sources. This makes it more difficult for small-sized companies to secure external funding. The difficulty in obtaining external funding increases the likelihood of small-sized companies experiencing financial distress compared to larger companies (Bui & Thach, 2023; Phan et al., 2022; Truong & Nguyen, 2022).

Internal financing for a company can be obtained from net earnings retained by the company and not distributed back to shareholders. These earnings have accumulated since the establishment of the company. The accumulation of earnings in young companies is much smaller compared to well-established companies. Insufficient internal funding to meet operational needs or other company requirements, such as expansion, will lead companies to seek external funding in the form of debt. Companies with debt obligations are also required to pay interest. Depending on debt can lead to an increase in both the amount of debt and the interest that must be paid (El-Ansary & Bassam, 2019).

Directors are required to manage the operational activities within a company and are responsible for making critical decisions for the financial health of the company. Directors may not necessarily be the owners or shareholders of the company. Directors may act in their own interest without considering whether it also benefits the company's owners. The separation between ownership and control in a company results in agency costs, meaning parties involved in the company have different interests. Each party seeks to maximize its own profit, resulting in losses for the other party. Thus, directors may act solely for their benefit, disregarding the interests of the company's owners (Mariano et al., 2021).

Corporate Governance provides oversight from top to bottom and regulates the company's risks. Corporate Governance manages the relationships among stakeholders, management, and directors in determining the direction and performance of the company. Senior management and directors have the responsibility to ensure that the existing risk management operates effectively. They need to ensure that stakeholders and business partners do not lose their money, employees do not lose their livelihoods, and other stakeholders are not adversely affected. Corporate governance enables them to manage the company's risks comprehensively (Hiles, 2012).

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Financial distress is influenced by cash flow, debt size, company size, retained earnings, and working capital. Research by (Bui & Thach, 2023) shows that there is a positive influence of debt and cash flow ratios on total debt in financial distress. Negative influences on financial distress are found in variables such as operating cash flow, company size, retained earnings, and working capital. From this research, managers need to manage the company's capital structure to reduce the likelihood of financial distress.

The statement of cash flows, indicated by receipts and disbursements of the company's operational activities, reflects the company's financial health. If the operating cash flow is positive, it indicates that the company can finance its operational activities internally, without relying on external funding. Thus, companies with a large amount of operating cash flow will avoid financial distress (Phan et al., 2022).

Debt is often necessary, especially for growing companies or those undergoing expansion. Companies need to regulate how much they can borrow and how to repay the debt. This is because increasing debt will be followed by high interest rates. Companies that cannot manage their finances will easily face difficulties in paying interest and principal debt. Such financial conditions will facilitate the company's experience of financial distress (Bernardin & Tifani, 2019).

A larger company size enriches the company with extensive experience, broad connectivity, and greater resources. This will make it easier for the company to obtain external funding and help the company avoid financial distress (Phan et al., 2022). Retained earnings accumulated over the years since the company was established are expected to provide internal funding to finance the company's operational and expansion activities. If the company cannot obtain funding internally, it will seek external funding, especially in the form of debt. With increasing debt, the amount of interest on the debt will also increase, potentially leading the company to experience financial distress (El-Ansary & Bassam, 2019).

Corporate governance is needed by companies to reduce the risks they face, which can, in turn, reduce the likelihood of bankruptcy. Research by (Mariano et al., 2021) found that an increasing number of directors will reduce the occurrence of financial distress. Meanwhile, an audit committee can also help oversee the company and reduce the likelihood of bankruptcy (Nugroho et al., 2020).

In contrast to previous research, this study examines more factors that affect financial distress including cash flow, debt, company size, retained earnings, the number of directors, and the audit committee. Thus, this study aims to determine the various factors that affect financial distress. The research hypothesis is as follows:

H1: There is an influence of cash flow on financial distress
H2: There is an influence of debt on financial distress
H3: There is an influence of company size on financial distress
H4: There is an influence of retained earnings on financial distress
H5: There is an influence of the number of directors on financial distress
H6: There is an influence of the audit committee on financial distress

## 2. Method

### Analysis Model

This research aims to analyze the influence of independent variables, namely operating cash flow, debt, retained earnings, company size, the number of directors, and the audit committee, on the dependent variable, which is financial distress. The research design uses a descriptive design, namely by providing a clearer picture of social situations for exploration and clarification of a phenomenon or social reality, by describing several variables related to the problem and unit under study. The measurement of the studied variables is as follows:

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Table 1
*Variable Identification and Measurement*

| Variable Type | Proxy | Symbol | Definition of Operational Variables | Reference |
|---|---|---|---|---|
| Variable Dependent | Financial Distress | FD | Zscore $Z = 1{,}2\ (X1) + 1{,}4\ (X2) + 3{,}3\ (X3) + 0{,}6\ (X4) + 1{,}0\ (X5)$ | (Truong, 2022) |
| Variable Independent | Operating Cash Flow | OCF | $\frac{\text{Operating Cash Flow}}{\text{Total Assets}}$ | (Bui & Thach, 2023) |
| | Debt | LEV | $\frac{\text{Total Amoun of debt}}{\text{Total Assets}}$ | (Bui & Thach, 2023) |
| | Size | SIZE | Log (Total Assets) | (Bui & Thach, 2023) |
| | Retained earning | RETA | $\frac{\text{Retained earning}}{\text{Total Assets}}$ | (Bui & Thach, 2023) |
| | Number of Directors | BS | Number of directors | (Mariano et al., 2020) |
| | Audit Committee | KA | Number of audit committees | (Pratama et al., 2022) |

The research uses quantitative data, and the data type used is secondary data collected from the financial reports of the companies under study listed on the Indonesia Stock Exchange. The population studied consists of all manufacturing companies listed on the Indonesia Stock Exchange (BEI) from 2018 to 2022, totaling 226 companies. The sampling technique used in this study is purposive sampling, where the sample is taken based on specific criteria. The criteria used for this sample are companies with complete data over 5 years and financial reports in Indonesian Rupiah. The obtained sample is 114 companies.

Table 2
*Sampling Criteria*

| Information | Amount |
|---|---|
| Manufacturing Companies listed on the Indonesian Stock Exchange in 2018-2022 | 226 |
| Companies that do not have reports in Rupiah (IDR) | (32) |
| Companies that do not have financial reports for 2018-2022 | (31) |
| Companies that do not have financial reports ending December 31 | (3) |
| Companies that do not have complete research variables in 2018-2022 | (46) |
| Total companies sampled | 114 |
| Total research data (114 companies x 5 years) | 570 |

**Chow Test**

The Chow test is used to select the better method between two methods: Fixed Effect or Common Effect. This test is based on the null hypothesis that there is no individual heterogeneity and the alternative hypothesis that there is heterogeneity in the cross-section. The cross-section Chi-square probability value is shown in Table 3. The cross-section Chi-square probability of 0.0000 < 0.005, thus the decision obtained is to reject the null hypothesis, and the model used is Fixed Effect. With the selection of the Fixed Effect model,

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the Hausman test will be conducted to determine whether the fixed effect or random effect model is used.

**Hausman Test**

This test aims to select the model between the fixed effect and random effect models. The test is also conducted to determine whether the model has heterogeneity in the characteristics of the model between fixed effect and random effect.

Table 3

*Chow Test and Hausman Test Results*

| Variable Dependent | *Chi-square* | Prob | Decision |
|---|---|---|---|
| FD | 685.745783 | 0.0000 | Rejected $H_0$, Fixed Effect selecte |
| FD | 75.384502 | 0.0000 | Rejected $H_0$, Fixed Effect selecte |

In Table 3 above, the cross-section statistic's probability value is 0.0000 < 0.05. Therefore, the decision obtained is to reject the null hypothesis, and the selected model is the Fixed Effect model.

**F-Test (Concurrent Test)**

The F-Test or concurrent test is conducted to test whether independent variables (Operating Cash Flow, Debt, Size, Retained Earnings, Number of Directors, Audit Committee) collectively impact the dependent variable (Financial Distress). The F-Test is aimed at testing the feasibility of using the regression model.

Table 4

*F Test Results*

| Dependent Variable | F-Statistic | Prob | Decision |
|---|---|---|---|
| FD | 79.64988 | 0.000000 | Rejected $H_0$ |

In Table 4 above, it is shown that the probability F-statistic produces a value of 0.000000 < 0.05. This result indicates that the independent variables, namely operating cash flow, debt, company size, retained earnings, the number of directors, and the audit committee, collectively have an impact on financial distress, making the regression model appropriate for use.

**Goodness of Fit Test (R2)**

The test measures how well the independent variables correlate in explaining the dependent variable and uses the Goodness of Fit test. This test employs the adjusted R2 value in multiple regression models. If the test result approaches 1, it means that the independent variables can explain the dependent variable.

Table 5

*Goodness of Fit Test Results*

| Variable Dependent | $R^2$ | Adjusted $R^2$ |
|---|---|---|
| FD | 0.954675 | 0.942689 |

In Table 5 above, the adjusted R-square value is found to be 0.942689. This indicates that the independent variables, including operating cash flow, debt, company size, retained earnings, the number of directors, and the audit committee, can explain the variation in financial distress by 94.2689%, while the remaining 5.7311% suggests that financial distress is influenced by other factors not included in this model.

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## 3. Results and Discussion

Table 6
*Descriptive Statistical Analysis Results*

| | FD | OCF | LEV | SIZE | RETA | BS | KA |
|---|---|---|---|---|---|---|---|
| Mean | 3,8670 | 0,0686 | 0,4645 | 12,2993 | 0,1792 | 4,7596 | 3,0175 |
| Maximum | 29,3005 | 0,4888 | 3,3875 | 14,4791 | 0,9485 | 13 | 5 |
| Minimum | -5,9477 | -0,2550 | 0,0630 | 8,6696 | -3,2346 | 2 | 2 |
| Std Dev. | 4,0249 | 0,1026 | 0,2916 | 0,7698 | 0,4320 | 2,1815 | 0,2959 |
| Observations | 570 | 570 | 570 | 570 | 570 | 570 | 570 |
| Cross sections | 114 | 114 | 114 | 114 | 114 | 114 | 114 |

Table 6 above shows the maximum value of financial distress in the Pharmaceutical Industry Sido Muncul Tbk in 2021 at 29.3005 and the minimum value in Tirta Mahakam Resources Tbk in 2022 at -5.9477. For the operating cash flow variable, the maximum value is found in Multi Bintang Indonesia Tbk in 2018 at 0.4888, and the minimum is in Alakasa Industrindo Tbk in 2020 at -0.2550. For the debt variable, the maximum value is in Tirta Mahakam Resources Tbk in 2022 at 3.3875, and the minimum is in Sucaco Tbk in 2021 at 0.0630.

In the company size variable, the maximum value is in Astra International Tbk in 2022 at 14.4791, and the minimum is in Eterindo Wahanatama Tbk in 2020 at 8.6696. The maximum value of retained earnings is found in Ultra Jaya Milk Tbk in 2022 at 0.9485, and the minimum is in Tirta Mahakam Resources Tbk in 2022 at -3.2346. The maximum number of directors was found in Mandom Indonesia Tbk in 2018. The maximum number of audit committee members is found in Malindo Feedmill Tbk during the research period.

Table 7
*Regression Analysis Results*

| Variable | Coefficient | Prob. | Information |
|---|---|---|---|
| C | 2,7887 | 0,0041 | |
| OCF | 1,5168 | 0,0000 | Significant positive |
| LEV | -3,4742 | 0,0000 | Significant negative |
| SIZE | 0,2143 | 0,0081 | Significant positive |
| RETA | 1,4688 | 0,0000 | Significant positive |
| BS | 0,0957 | 0,0084 | Significant positive |
| KA | -0,2542 | 0,0407 | Significant negative |

### Discussion

### Influence of Operating Cash Flow on Financial Distress

In Table 7, a significantly positive result is obtained between the operating cash flow variable and financial distress. With a positive coefficient of 1.5168 and a probability value less than 0.05, which is 0.0000, there is a positive and significant influence of the operating cash flow variable on financial distress. In this study, the Z-score is used for financial distress calculation, where a higher Z-score reduces the risk of financial distress. A positive coefficient implies that a larger operating cash flow will decrease the occurrence of financial distress in manufacturing companies in Indonesia. This result supports previous research by Bernardin & Tifani (2019) which states that there is a significant influence with a negative direction between cash flow in predicting financial difficulties.

### Influence of Debt on Financial Distress

In Table 7, a probability value of 0.0000 is obtained with a coefficient value of -3.4742 for the LEV variable. This indicates a significantly negative influence between debt and financial distress in manufacturing companies in Indonesia. In this study, the Z-score is used for financial distress calculation, where a lower Z-score increases the risk of financial distress. In

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this case, it means that a larger debt will increase the potential for financial distress. This result supports previous research by Indarti et al.(2020).

**Influence of Company Size on Financial Distress**

In Table 7, a coefficient of 0.2143 is obtained with a probability value of 0.081. This data shows a significantly positive influence between the company size variable and financial distress in manufacturing companies in Indonesia. In this study, the Z-score is used for financial distress calculation, where a larger Z-score reduces the risk of financial distress. Thus, a larger company size will be more immune to financial distress. The same conclusion is drawn by Isayas, (2021) which states that Firm size is found to have a negative and significant effect on financial distress and this indicates that firms with large size as measure by their total assets will be in a better position of financial health and in turn minimize their bankruptcy risk.

**Influence of Retained Earnings on Financial Distress**

The data analysis results in Table 7 show a coefficient value of 1.4688 with a probability value of 0.0000. This data indicates a significantly positive relationship between retained earnings and financial distress in Indonesian manufacturing companies. In this study, the Z-score is used for financial distress calculation, where a larger Z-score reduces the risk of financial distress. Therefore, it is interpreted that the larger the retained earnings, the more the company is protected from financial distress. This research result supports previous studies by Mariano et al. (2021) which states that companies with low ownership concentration, and low degree of independence are more likely to incur financial distress. Larger boards and better director remuneration can reduce financial distress likelihood and the existence of corporate loans can increase this likelihood. Empirical consideration of corporate borrowing is a new contribution to the literature.

**Influence of the Number of Directors on Financial Distress**

In Table 7, a coefficient of 0.0957 is obtained with a probability value of 0.0084. This data shows a significantly positive relationship between the number of directors and financial distress in manufacturing companies in Indonesia. This study uses the Z-score for financial distress calculation, where a larger Z-score reduces the risk of financial distress. This result also means that a larger number of directors in manufacturing companies will prevent the company from financial distress. Similar conclusions were reached by Manduku et al. (2020) which states that significant influence of institutional ownership on financial distress, the study concluded that an ownership structure characterized by a high percentage of institutional ownership reduces the occurrence of financial distress.

**Influence of Audit Committee on Financial Distress**

In Table 7, a probability value of 0.0407 is indicated with a coefficient of -0.2542, showing a significantly negative relationship between the audit committee variable and financial distress in Indonesian manufacturing companies. The measurement of financial distress uses the Z-score, where a larger Z-score reduces the risk of financial difficulty. A larger audit committee will increase the risk of the company experiencing financial distress. Similar results were obtained by Widiyanto & Dwijayanti, (2022) which states that the Audit Committee has a significant positive effect on the financial distress of banking companies for the 2018-2020 period. A larger number of audit committees may not necessarily take part or affect the financial performance of the company and even many audit committees will tend to lose focus and participate less.

## 4. Conclusion

The results of the study can be concluded that operating cash flow has a positive effect on financial distress. The company size variable and financial distress have a positive effect.

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Retained earnings and financial distress have a positive effect. Meanwhile, Debt on, The audit committee, and company size have a negative effect on financial distress. With the above test results, the following benefits can be derived:

a) Management: To avoid the possibility of financial distress in the company, management can pay attention to influencing factors. It is essential for management to consider the operating cash flow condition to meet the company's operational needs and short-term debt. Management needs to pay attention to an adequate amount of debt that can meet the company's investment needs without causing payment difficulties in the future. Management can also consider the company's size, with a larger size expected to provide higher sales/profits. Management also needs to look at the amount that can be distributed as dividends to shareholders, while the rest can be used by the company as internal funding. The number of directors can be adjusted to the size and needs of the company. A larger company will require more directors than a smaller one. The audit committee can help the company monitor operational activities, but the number and needs of the company should also be reviewed.
b) Investors: The influence of the examined factors on financial distress provides information for investors in investing their capital. Factors such as operating cash flow, debt, company size, retained earnings, the number of directors, and the audit committee that a company has can provide information about the survival of a company. This can help investors choose companies to invest in.

**Suggestions and Limitations of the Study**

From the above research results, this study has limitations, including being limited to variables related to operating cash flow, debt, company size, retained earnings, the number of directors, and the audit committee. The study was also conducted only in the manufacturing industry and within a 5-year period. For future research, additional independent variables such as the age of the company (Isayas, 2021) can be considered. The study can also explore industries other than manufacturing and extend the study period.

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