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The Effect of Leverage, Liquidity and Profitability on Financial Distress with the Effectiveness of the Audit Committee as a Moderating Variable

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ABSTRACT

This study aims to analyze and describe the effect of variable leverage, liquidity, and profitability on financial distress with the addition of moderating variables, the effectiveness of audit committee. Mining companies listed on the Stock Exchange in 2013-2016 are the population in this study, which consisted of 48 companies each year. The purposive sampling method is used to select the sample so that there are 80 analysis units from 20 companies. The data analysis technique in this research used moderating regression analysis with IBM SPSS for windows version 21.0. The result of this research showed that leverage, liquidity, and profitability have no significant effect on financial distress. Effectiveness of audit committee has proven to be a moderating variable between the variables of leverage and profitability of financial distress, but cannot be a moderating variable between the variables of liquidity and financial distress. The conclusion of this research is control from audit committee to the management company will improve management performance so it will avoid the company from possible happening of financial distress.

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INTRODUCTION

The rapid development of the business world in the era of globalization is marked by the increasing number of new companies. Poor management of the company will bring the company into various problems, one of which is financial problems or financial distress. Financial distress is a condition that describes corporate financial condition is not good and experiencing difficulties. Companies that are experiencing financial distress if they are not immediately dealt with correct policies will lead to bankruptcy. Financial distress predictions for companies are important. With the prediction of financial distress will help companies in reducing symptoms that lead to bankruptcy. Given the importance of financial distress as the initial signal of bankruptcy, it must be dealt with appropriate decision making by management.

The state of the economy of a country greatly influences the possibility of companies experiencing financial distress. One of the signals that the company is experiencing financial distress is a decline in financial conditions before the company is declared bankrupt (Platt & Platt, 2002). This condition will lead to a bankruptcy. When a company experiences bankruptcy, it indicates that the company has really failed in carrying out its business. Therefore, when a signal emerges, the company experiences financial distress, so as early as possible it must make various efforts to maintain its survival (Going Concern). The importance of realizing the initial signal of financial distress has become a necessity for companies.

One sign of the occurrence of financial distress is an increase in debt which will increase the cost of interest as well. If management in managing the company is not good, there will be inability to pay debts and interest costs. In order to be able to escape the problem, the company is expected to improve its performance.

This study will try to examine the factors that influence the occurrence of financial distress in mining companies. This is based on the fact that mining companies are considered to be one of the sectors that often experience conditions of financial difficulties. This fact is supported by the condition of the global economy which has caused mining commodity prices to weaken, which has become one of the factors of flagging mining companies and ultimately experiencing financial distress. The weakening of mining commodity prices causes the export value to be low but the production costs are high, so many companies suffer losses. When

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production costs are high, the company will try to find additional funds such as debt. The use of debt that is not managed properly will cause financial difficulties for the company. This is because the use of high debt will also cause high interest costs.

Mining is one of the companies that will feel the greatest impact when the global crisis occurs. As reported by Tribunnews.com (2015) which stated that in 2015, the mining sector shares were the most depressed due to coal prices which had not gradually recovered. For example, some shares of mining companies have dropped drastically, such as shares from PTBA which experienced decline of Rp. 7,200 per share, with a price per share at the beginning of the year of Rp. 11,800 to Rp. 4,600 at the end of the year. The impact of the economic crisis caused various problems for the company. To avoid things that will lead to bankruptcy, companies must be able to detect signals of financial distress.

Many factors influence financial distress as in previous studies with various proxies and results. Bodroastuti (2009), Deviacita & Achmad (2012), Hanifah & Purwanto (2013), Alifiah (2014), Kusanti & Andayani (2015), Kristanti, et al. (2016), Antikasari & Djuminah (2017), (Salloum, et al. 2014), (Manzaneque, et al. 2016), (Ufo, 2015), (Brédart, 2014), and (Jamal & Shah, 2017) examined the factors that can trigger the occurrence of financial distress in the company. The factors are leverage, liquidity, profitability, activity ratio, managerial ownership, institutional ownership, board of directors, board of commissioners, board of independent commissioners, audit committee, and company size.

Factors that can encourage companies to experience financial distress to be examined in this study consist of 4 (four) variables with results that are still inconsistent and the addition of a moderating variable. Leverage variable has a positive effect on financial distress. (Hanifah & Purwanto, 2013; Antikasari & Djuminah, 2017). Leverage has no effect on financial distress (Kusanti & Andayani, 2015; Aisyah, Kristanti, & Zultilisna, 2017). Liquidity has a negative effect on financial distress (Antikasari & Djuminah, 2017; Kholidah, et al. 2016). Liquidity has no effect on financial distress (Hanifah & Purwanto, 2013). Profitability has a negative effect on financial distress (Alifiah, 2014; Kuncoro & Agustina, 2017). Profitability has no effect on financial distress (Kristanti, Rahayu, & Huda, 2016; Hanifah & Purwanto, 2013).

This study aims to examine what factors can trigger financial distress in mining companies that are listed on the Indonesia Stock Exchange (IDX). The factors that are assumed to influence financial distress in this research are leverage, liquidity, and profitability. The effectiveness of audit committee is added as a moderating variable to see whether the possibility of a company experiencing financial distress can be strengthened by the effectiveness of the audit committee in the company.

The measurement of the independent and moderating variables in this study uses various indicators. First is leverage which uses the Debt to Equity Ratio (DER) measurement. Second, liquidity that uses Current Ratio (CR) as the measurement. Third, profitability that uses the Return on Equity (ROE) ratio as the measurement, and the effectiveness of audit committees measured using the frequency of audit committee meetings in one year.

This research uses Agency Theory. According to agency theory, principals and agents have different interests between one another. A conflict of interest arises because of the information asymmetry between the owner of the company and management. Management knows more information because they are directly involved in managing the company than the owner of the company who does not fully know the real condition of the company. Companies use agency costs to minimize conflicts between managers and corporate owners.

When the value of the leverage ratio is high, it shows that corporate funding comes mostly from debt. If it is not managed as well as possible, it will cause the company to be in financial distress. When the value of the leverage ratio is high, the company has an obligation that must be borne from the acquisition of corporate funds that are not balanced with the assets that exist in the company, so that companies experiencing financial difficulties (financial distress). But when the company has a small leverage value, the possibility of the company experiencing financial distress also decreases. Large leverage value shows that the proportion of the company's external funds is greater than the company's internal funds. According to agency theory, the use of corporate debt will give rise to agency costs. Leverage is a ratio that shows how much debt is used as a source of corporate funding. Hanifah & Purwanto (2013) as well as Antikasari & Djuminah (2017) found empirical evidence that when the debt ratio is high, the percentage of companies experiencing financial distress will increase.

H_1: Leverage has a positive effect on financial distress

Liquidity is one of the means of management in carrying out accountability to the principal. Liquidity shows the company's ability to fulfil its current obligations. The high value of the company's liquidity shows that the company's ability to pay off its current liabilities is good. Thus, the company will avoid the possibility of financial distress.

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Agency theory states that there is a conflict of interest that arises between the owner and management of the company. This conflict arises due to the information asymmetry between the two parties. Liquidity is one of management's responsibilities to the owner of the company. Management is responsible for stakeholders through disclosure of financial performance in the annual report and financial reports issued by the company are tools that can be used for decision-making. When the value of the liquidity ratio is high, it indicates that the company's ability to pay off current liabilities owned

can be said to be good. Research conducted by Alifiah (2014), Antikasari & Djuminah (2017), as well as Kholidah *et al.,* (2016) show the results that when the value of the liquidity ratio increases, the company can pay off its current liabilities at maturity, so that the company will avoid the possibility of experiencing financial distress. The higher the liquidity, the percentage of companies experiencing financial distress will decrease.

H_2: Liquidity has a negative effect on financial distress

Profitability is a ratio that reflects corporate profits. Corporate profit becomes an important thing because it becomes the foundation in a decision-making. When the profitability ratio is high, the performance is considered good because it can generate high profits from the company's operations. When the corporate profits are large, then the company will reduce the use of debt so that the possibility of financial difficulties or financial distress will decrease.

Agency theory explains in a company there is a separation of interests between owners and agents that can cause conflict. Agents who are corporate management know all the conditions that exist in the company, while the owner does not know the full conditions in the company. Profitability is one of management's responsibilities in carrying out their duties. With the existence of this profitability ratio, the owner can find out how the conditions inside the company briefly. Companies that have high earnings can be interpreted that the company's management is successful in managing the company so that the goals of both parties are achieved and can minimize conflicts that occur in the company.

High profitability indicates that the company has good financial conditions and can avoid the possibility of financial distress. Research conducted by Kholidah*et al.,* (2016), Kuncoro & Agustina (2017) as well as Alifiah (2014) give results, namely profitability has a negative effect on the possibility of financial distress. This indicates when the profitability ratio is high, the company will reduce the use of debt in the company which can reduce the possibility of experiencing financial distress.

H_3: Profitability has a negative effect on financial distress

When the level of audit committee effectiveness in a company is getting better, it can improve performance and guide management in choosing the right decision, so that it can prevent companies from the possibility of financial distress. This reflects the role of the effectiveness of the audit committee that can moderate or strengthen and weaken the influence of leverage on the company's financial distress.

Agency theory explained by Jensen & Meckling (1976) states that agency problems that arise in the company can be minimized in several ways. Among them is increasing supervision in the company. The better the supervision in the company, the better management decisions on a policy. This is due to management will feel more monitored so that the performance will also increase. The effectiveness of audit committees plays a role in the influence of leverage on financial distress. Companies with a high level of audit committee effectiveness show that supervision in the company is good, so managers will take appropriate policies regarding the level of debt (leverage) used by the company. This can prevent companies from financial distress.

H_4: Leverage affects on financial distress by being moderated by the effectiveness of the audit committee

The existence of high audit committee effectiveness ensures that the company has good supervision towards the management. Agency theory states that the conflict between owners and agents is due to differences in interests. With the existence of independent parties such as the audit committee and supported by the effectiveness of the audit committee, it will improve the performance of the management. Because of good supervision, management will not only think about their own welfare but also the welfare of the company which has become the responsibility of management. So that there will be harmony between the owner and management. High effectiveness of audit committee will improve management performance so that the liquidity ratio is higher and can prevent companies from the possibility of financial distress. The description explains that the effectiveness of an audit committee can be used to moderate the effect of liquidity on financial distress

H_5: Liquidity has an effect on financial distress moderated by the effectiveness of the audit committee

High profitability is a reflection of the good performance of the company's management. This cannot be separated from the supervision carried out by independent parties to the management. This is in accordance with agency theory where management must be accountable to the owner, which can be seen from the level of profitability. Agency theory states that the conflict between owners and agents is due to differences in interests. With the existence of independent parties such as the audit committee and supported by the effectiveness of the audit committee, it will improve the performance of the management. When the supervision carried out by the audit committee is increasingly effective, the profitability of the company will also increase. So the possibility of companies experiencing financial distress will decline.

Good management performance cannot be separated from the supervisory role within the company carried out by the audit committee. The effectiveness of the audit committee is a target achievement in the company. In order for the goal to be achieved, it is necessary to have supervision from an independent party, which means the audit committee. The higher the effectiveness of the audit committee, the higher the supervision of the company management, so that its performance will be better and can produce high profitability. High profitability can prevent a company from a condition of financial distress or financial difficulties. So, the variable effectiveness of the audit committee can be used to moderate the

effect of profitability on financial distress.

H_6: Profitability affects on financial distress moderated by the effectiveness of the audit committee

RESEARCH METHOD

This research was a quantitative research which aims to examine the factors that influence financial distress. This study used a study of testing causality hypotheses as a research design. Secondary data in this study were collected using documentation techniques. A total of 48 mining companies that were listed on the IDX in 2013-2016 were made as sample companies in this study. The sampling technique used a purposive sampling technique with the criteria presented in table 1 below.

Financial distress was the dependent variable in this study. The independent variables in this study were leverage, liquidity, and profitability. The effectiveness of the audit committee was the moderating variable in this study. The operational definitions of variables in the study are presented in Table 2.

The data used in this study were sourced from the financial reports and annual reports of the mining companies listed on the IDX. The testing used two methods, namely descriptive statistical analysis and inferential statistical analysis. Inferential statistical analysis was divided into classical assumption tests, moderating regression analysis and hypothesis testing using IBM SPSS for windows version 21.0. Moderation regression analysis with the absolute difference value test was used as the hypothesis testing in this study. This study also used the classical assumption test which was carried out before hypothesis testing. The model of this research can be formulated 1.

$$FD = \alpha + \beta 1LEV + \beta 2LIK + \beta 3PRO + \beta 4|LEV\text{-}KA| + \beta 5|LIK\text{-}KA| + \beta 6|PRO\text{-}KA| + e \quad (1)$$

RESULTS AND DISCUSSIONS

To find out the description of each research variable, descriptive statistical analysis was carried out. Analysis of this study includes analysis of minimum, maximum, average and standard deviation values. The

Table 1. Sample Selection Criteria

Sample Criteria	Beyond Criteria	Number
Mining companies listed on the IDX		46
Mining companies that did not publish complete annual report for the period 2013 – 2016	(16)	30
Companies have all the data needed in this study	(7)	23
Number of sample companies		23
The amount of research data in the observation period		92
Data outlier during observation period		(12)
Number of analysis units		80

Source: secondary data processed (2018)

Table 2. Variable Definitions and Measurements

Variables	Definition	Measurement	Scale
Financial Distress (FD)	The condition of the company's financial difficulties and occurred before bankruptcy (Platt and Platt, 2002)	$ICR = \frac{EBIT}{Interest\ Expense}$ (Asquith, Gertner, & Scharfstein, 1994)	Ratio
Leverage (LEV)	The ratio that shows how much debt is used in the company (Sudana, 2015)	$DER = \frac{Total\ Debt}{Total\ Equities}$ (Kasmir, 2014)	Ratio
Liquidity (LIK)	Financial ratio that measures the company's ability to pay off current liabilities (Sudana, 2015)	$CR = \frac{Current\ Asset}{Current\ Debt}$ (Hanifah and Purwanto, 2013)	Ratio
Profitability (PRO)	Ratio that measures the company's ability to generate profits (Sudana, 2015)	$ROE = \frac{Earning\ After\ Tax}{Total\ Equity}$ (Sudana, 2015)	Ratio
Effectiveness of the Audit Committee (KA)	The intensity of audit committee meetings in one year (Nuresa and Hadiprajitno, 2013)	Efectiveness of the Audi Committee=intensity of audit committee meetings (Pamudji & Trihartati, 2010)	Ratio

Sources: various sources

Table 3. Result of Descriptive Stastical Analysis

	N	Minimum	Maximum	Mean	Std. Deviation
FD	80	-15.73	48.74	5.6053	10.23366
LEV	80	0.14	1.11	0.5140	0.22295
LIK	80	0.18	5.07	1.8246	0.99541
PRO	80	-0.74	0.72	0,.0129	0.24748
KA	80	3.00	61.00	11.6000	11.58742

Source: *Output* SPSS 21, 2018

Table 4. Summary of Hypothesis Testing

No	Hypothesis	Explanation	Coefficient	Sig.	Results
1	H_1	Leverage has a positive effect on financial distress.	-6.421	0.000	Rejected
2	H_2	Liquidity has a negative effect on financial distress.	-1.883	0.095	Rejected
3	H_3	Profitability has a negative effect on financial distress.	4.826	0.000	Rejected
4	H_4	The effectiveness of the audit committee moderates the influence of leverage on financial distress.	3.800	0.045	Accepted
5	H_5	The effectiveness of the audit committee moderates the liquidity effect on financial distress.	2.399	0.104	Rejected
6	H_6	The effectiveness of the audit committee moderates the effect of profitability on financial distress.	-4.571	0.003	Accepted

Source: Secondary Data Processed, 2018

results of the analysis can be seen in Table 3.

The classical assumption test done using SPSS 21.0 shows that data is normally distributed with a significance value of 0.078> 0.05. VIF value <10 with a tolerance value> 0.01 indicates that there are no symptoms of multicollinearity in this study. Heteroscedasticity test in this study uses a white test which shows that the value of c^2 count (27.76) is smaller than c^2 table (101.88) 27.76 <101.88. So the conclusion, there is no symptom of heteroscedasticity in this study. The autocorrelation test was done using a run test which produced a significance value of 0.115> 0.05, so that there was no autocorrelation in this study.

Adjusted R square value of 0.334 means that the variables of leverage, liquidity, and profitability as well as the effectiveness of the audit committee as the moderating variable have an effect of 33.4% on financial distress. Meanwhile, the rest is influenced by other variables outside this study of 66.6%. The results of the hypothesis test summary can be seen in table 4.

The Effect of Leverage on Financial Distress

This study shows the result that leverage has a negative influence on financial distress. This does not support the first hypothesis which states that leverage has a positive influence on financial distress. This is not in line with agency theory, where the use of corporate debt will give rise to an agency cost. Leverage is one of the financial ratios to see how much corporate funding uses external debt or funds. Companies that have high leverage ratios are usually included in companies that are indicated to experience financial difficulties.

Leverage has a negative influence on financial distress is assumed because even though the company has a lot of debt but the company is still able to pay off the debt and interest from the debt. This result is supported by research conducted by Kristanti *et al.,* (2016) which states that even though the company has a large amount of debt, the company still has good performance. So even though the debt level is high, the possibility of financial distress will actually decrease because the company is still able to pay off the interest generated from the debt. The result of this study supports the research conducted by Kristanti *et al.,* (2016) and Alifiah (2014) which states that leverage does not affect the possibility of companies experiencing financial difficulties or financial distress.

The Effect of Liquidity on Financial Distress

The result of this study states that liquidity has no effect on financial distress. The result of this study does not support agency theory which states that the occurrence of a conflict of interest between the owner of the company and the management of the company is due to differences in interests. Basically, management has a responsibility to the owner of the company to prepare information in order to make company decisions by the owner of the company. Where the decision chosen must cover the benefits of all parties. One of which by maximizing and satisfying the objectives of the principal and corporate management (agent). Liquidity is one of the means of management in carrying out responsibilities to the principal. Thus, it will minimize the occurrence of conflicts of interest.

In this study, liquidity is not proven to have an influence on financial distress. This is because even though the company has high short-term obligations, the company is still able to pay it off on time. This result supports previous research conducted by (Hanifah & Purwanto, 2013) which indicates that companies that have low short-term obligations focus more on their long-term obligations. It can be concluded that liquidity has no effect on financial distress. According to agency theory, when a corporate liquidity increases, the percent-

age of the company should experience financial distress decrease. However, the result of this study is not in accordance with what has been formulated in the hypothesis. The result of the tests above if associated with previous research are relevant to the research conducted by Hanifah & Purwanto (2013) which shows that liquidity is not one of the factors that can affect the occurrence of financial distress. This result also supports the research of Prasetyo & Fachrurrozie (2016), which confirms that liquidity has no effect on the possibility of companies experiencing financial distress.

The Effect of Profitability on Financial Distress

This study shows that profitability has a positive effect on financial distress. This means that the third hypothesis which states that profitability has a negative effect on financial distress is rejected. This does not support agency theory where there is a separation of interests between the owner and the manager of the company which can create a conflict of interest between the owner of the company and the agent. Profitability is one of management's responsibilities in carrying out its duties. With the existence of profitability will also reduce the conflict that occurs, because from this information the owner of the company can find out the conditions in the company.

The results of this study support the research conducted by Kristanti *et al.,*(2016) and Hanifah & Purwanto (2013) which shows that profitability has no effect on financial distress. The higher the value of profitability that the company has shows that the company is able to generate profits from the sources it has. However, this is not proven in the results of the study, because profitability in this study has a positive beta coefficient direction. This shows that the higher the value of profitability, the higher the possibility of financial distress.

The effectiveness of the Audit Committee moderates the Effect of Leverage on Financial Distress

This study gives result that the effectiveness of the audit committees is able to moderate the effect between leverage and financial distress. The result of the study states that the effectiveness of the audit committee can strengthen the effect between leverage and financial distress. The effectiveness of the audit committee which is high shows a good corporate performance so that the company will avoid the possibility of financial distress. This result is supported by the result of previous research conducted by Nuresa & Hadiprajitno (2013) who argued that the frequency of audit committee meetings is able to give changes in management behavior so that they will produce the right decisions. This explains that the increase in the possibility of companies experiencing financial difficulties that is influenced by the level of corporate leverage depended on the supervision in the company.

This result supports agency theory which states that to reduce conflicts that exist within the company can be done in various ways, including by increasing supervision in the company. This result supports the view of agency theory which states that to minimize conflicts that exist within the company must be conducted optimal supervision proved. This is indicated by the effectiveness of the audit committee which proven succeeded in moderating the influence of leverage on financial distress.

The effectiveness of the Audit Committee moderates the Effect of Liquidity on Financial Distress

The result of the study indicates that the effectiveness of the audit committee cannot moderate the effect of liquidity on financial distress. This result indicates that the high and low influence of liquidity on financial distress does not depend on the effectiveness of the audit committee. This result is not in accordance with the agency theory which explains that liquidity is one of the means of management in reducing conflicts of interest between owners and managers of companies, in addition to reducing the conflict that occurs, it can also be done by increasing supervision of management. When the audit committee is more effective it indicates that supervision in the company is also increasing. So that the management's performance gets better and will prevent the company in financial distress by taking the right policy.

Liquidity is the company's ability to pay for its current liabilities. The audit committee in carrying out one of its tasks, namely supervision will improve the performance of the company's management so that management can increase the company's liquidity. This can prevent companies from financial distress. However, this is not proven in the results of this study, because the presence or absence of the effectiveness of the audit committee within the company will not affect the relationship between liquidity and financial distress. This can happen because the average frequency level of audit committee meetings at the companies is still less effective. This can be seen in the descriptive statistics table which shows the mean value of the variable of the audit committee effectiveness is still far from the maximum value.

The effectiveness of the Audit Committee moderates the Effect of Profitability on Financial Distress

The result of this study indicates that the effectiveness of the audit committee is able to moderate the effect of profitability on financial distress, so that the sixth hypothesis is accepted. This result indicates that the presence of the effectiveness of the audit committee as moderating causes profitability to have a significant negative effect on financial distress. This means that the higher the profitability with the more effective the audit committee will reduce the occurrence of financial distress in the company. Profitability is one of management's responsibilities to the owner of the company that will be more effective if it is supported by a good level of supervision.

This is in accordance with the agency theory which explains that a good management performance will reduce conflicts between owners and managers of

the company. A good management performance can improve its financial performance so that it will avoid from financial distress. Companies with a high level of audit committee effectiveness show that the supervisory function in the company is running properly. This finding proves empirically that the effectiveness of the audit committee is able to moderate the effect of profitability on financial distress. So that means profitability that affects the possibility of companies experiencing financial distress depending on the level of supervision of the audit committee. The more effective supervision carried out by the audit committee will improve management performance, so that the value of profitability increases and avoids the company from financial distress.

CONCLUSIONS

The conclusions from this study are leverage, liquidity, and profitability have no effect on financial distress. The effectiveness of the audit committee proved can be a moderating variable that can control the influence between leverage and profitability with financial distress, but it cannot moderate the effect of liquidity on financial distress. The suggestion for the next researcher is to use a different company sector, this is because financial distress is a crisis that strikes all levels of the company and also to see whether there are different results or not with this research. Using other variables of Good Corporate Governance (GCG) as a moderating variable, this is supported by the proof of the effectiveness of the audit committee in moderating the effect of profitability on financial distress.

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