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Original Research Article

Effect of Cash Flow, Profit and Corporate Governance on Financial Distress Conditions

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Abstract: In 2008, Indonesia witnessed a global financial crisis. Due to variations in the rupiah currency rate, importers encountered financial difficulties, which was one of the effects. On September 3, 2019, the exchange rate between the rupiah and the U.S. dollar fell to 14,230 per dollar. This Study's Objective Is To Evaluate The Impact of Cash Flow, Profit, And Corporate Governance On Financial Disaster Conditions (Study on Manufacturing Companies Listed on the Indonesia Stock Exchange in 2015-2018). Secondary data from the 2015-2018 annual reports of manufacturing enterprises collected from www.idx.co.id were used for this study. There are 135 manufacturing enterprises in all. There are 22 manufacturing enterprises in the sample. The findings revealed that the Cash Flow Variable had no impact on financial distress. Variable profit has a detrimental impact on financial distress. The Board of Directors variable does not affect financial distress. The Board of Commissioners variable does not affect financial distress. The variable Institutional Ownership hurts financial distress. The contribution of research to the firm's Board of Directors is a consideration of the company's financial status in order for the company to have good financial reports and prevent financial difficulty. Investors and creditors must pay close attention to the company's. Financial condition and be selective and cautious about the company's actual condition.

Keywords: Cash Flow, Profitability, Corporate Governance, Financial Distress.

1. INTRODUCTION

In 2008, Indonesia experienced a global financial crisis. One of the impacts was imports which experienced financial difficulties due to fluctuations in the rupiah exchange rate. On September 3, 2019, the rupiah exchange rate against the US dollar weakened to reach 14,230 per US dollar, down 0.25 per cent compared to the previous day's closing at 14,197 (www.kompas.com). The weakening of the rupiah exchange rate impacts the manufacturing industry in Indonesia. Because it still has a dependence on imported raw materials, and the supply of local raw materials is insufficient (www.kemenperin.go.id). The fluctuation of the rupiah exchange rate causes the probability that the company will experience financial distress or financial distress. In general, financial distress is the financial condition of a company that experienced a decline before bankruptcy.

Cash flow is the amount of cash in and out of operating, financing and investing activities in a certain period. Cash flow can be used to pay off company loans to avoid financial distress—profit results from income minus expenses in the company's income statement. If the company reports profits, it will avoid financial distress because it can manage its assets effectively in generating profits. The board of directors is a component of the corporate governance process that aids corporations in formulating policies and evaluating financial decisions to prevent financial crises. The board of commissioners oversees the implementation of the company's policies as defined by the board of directors. The larger the board of commissioners, the greater the level of supervision of firm policies so that the institution's financial suffering will be minimal. Ownership refers to an institution's ownership of shares in a corporation, which helps control the performance of management. The more institutional ownership, the better the institution's capacity to supervise management performance, reducing the severity of the company's financial hardship.

2. CONCEPTUAL FRAMEWORK

2.1 Agency Theory

According to Godfrey (2010) in Henry (2017), agency theory is a contractual connection between the firm owner (principal) and management (agent), in which the company owner permits management to carry

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out the operational operations of the business. The corporate governance system strives to produce added value for all interested parties, so that company owners and managers have no conflicts of interest and their interests are aligned.

2.2 Signal Theory

According to Novianita (2017), the signal theory is a theory that reveals and gives signals to users of financial statements carried out by the company. Through signal theory, company management will instruct external parties, such as investors, on assessing the company's prospects. Company information that can be a signal for external parties such as investors is in the form of accounting and non-accounting information written in the company's annual report.

2.3 Definition of Financial Distress

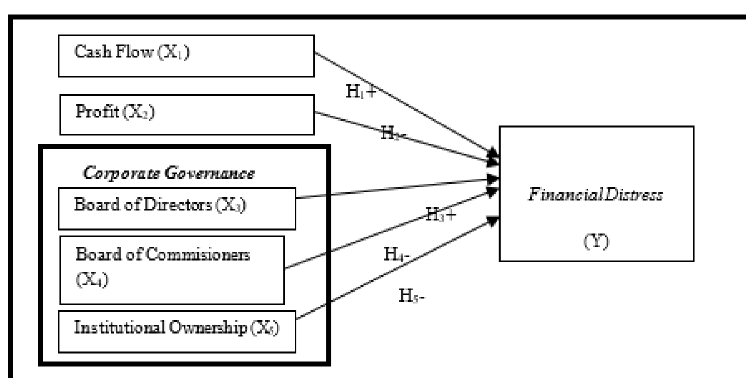
According to Henry (2017: 33-35), financial distress is a circumstance in which a business experiences financial difficulties. Financial hardship occurs when a firm cannot pay its financial obligations because its income is insufficient to cover its expenses and incurs losses.

2.4 Aspects influencing Financial Distress

According to Hanafi and Halim (2016: 58-62), cash flow impacts financial distress. The cash flow statement is a report used to examine the company's cash inflow and outflow. This cash flow report examines the cash consequences of a company's operating, investing, and financing operations over a specific period. Henry (2017: 41-43) states that the following variables contribute to financial distress: Profit. Profit is measured by the profitability ratio, which is determined using return on assets. This return on asset profitability ratio is used to evaluate the efficiency with which corporate assets are utilized. Corporate Governance is a collection of mechanisms that regulate and control a business to generate value for its stakeholders. The proportion of a company's shares owned by institutions such as insurers, banks, investment companies, and other institutional Ownership is one of the corporate governance techniques. According to Widyasaputri (2012: 3-6), the following causes contribute to financial distress: The Board of Directors can alter financial situations because every action made by the company is based on board decisions. The Board of Commissioners supervises the board of directors' policies.

2.5 Framework

The framework of thought in this research is as follows:



Hypothesis

Effect of Cash Flow on Financial Distress

Cash flow is the amount in and out in a certain period. The cash flow used by creditors in providing loans can determine the company's ability or inability to pay the company's debts. The research of Santoso *et al.,* (2017) states that cash flow does not affect financial distress. Based on the description above, the following hypothesis can be formulated:

H1: Cash Flow has a positive effect on the occurrence of financial distress

According to Yustika's (2015) research, return on assets-calculated profitability has a detrimental impact on financial distress. The company's significant profitability indicates its potential to make big profits, thereby protecting it from financial difficulties. Based on the preceding description, the following hypothesis can be formulated:

H2: Profit negatively impacts the incidence of Financial Distress situations.

The board of directors plays a crucial role in establishing policies and making financial choices. According to Widyasaputri's (2012) research, the number of board directors substantially impacts financial distress. The board of directors can affect the company's financial condition since its choices affect its financial condition. Based on the preceding description, the following hypothesis can be formulated:

H3: The Board of Directors influences the incidence of financial trouble positively

The Board of Commissioners oversees the implementation of corporate policies decided by the board of directors. The amount of monitoring the application of corporate policy is proportional to the number of commissioners in the organization. According to Widyasaputri's (2012) research, the board of commissioners has little effect on financial hardship situations. Based on the preceding description, the following hypothesis can be formulated:
H4: The Board of Commissioners hinders the occurrence of economic hardship

Institutional Ownership refers to the Ownership of firm shares by institutions that oversee the performance of management. According to PAyuningtias's (2013) research, institutional Ownership exacerbates financial suffering. The more extensive institutional Ownership will induce a higher level of management performance oversight. Based on the preceding description, the following hypothesis can be formulated: H5: Institutional Ownership prevents the likelihood of financial crisis.

3. RESEARCH METHODS

3.1 Sample and Data

Secondary data from the 2015-2018 annual reports of manufacturing enterprises collected from www.IDX.co.id were used for this study. There are 135 manufacturing enterprises in all. The selection of a sample of 22 manufacturing enterprises is based on the following criteria: list a manufacturing firm on the Indonesia Stock Exchange between 2015 and 2018, the company's financial results for 2015-2018 are shown in rupiah units, the organization provides annual financial reports for 2015 through 2018, including the variables considered in this analysis, and manufacturing enterprises that encounter financial difficulties and those that do not.

3.2 Definition of Operational Variability

In this study, the dependent variable is financial distress; a binary dummy variable with a binomial size board of commissioners does not affect financial distress. Based on the preceding description, the following hypothesis can be formulated: Institutional Ownership refers to the Ownership of firm shares by institutions that oversee the performance of management. According to PAyuningtias's (2013) research, institutional Ownership exacerbates financial suffering. The more extensive institutional Ownership will induce a higher level of management performance oversight. Based on the preceding description, the following hypothesis can be formulated: Institutional Ownership hurts the occurrence of financial distress conditions.

3.3 Dependent Variable

In this study, the dependent variable is financial distress, which is presented as a binary variable in the form of a dummy variable with a binomial size, namely one (1) if the company is experiencing financial difficulty and zero (0) otherwise. According to Henry (2017: 37), the Altman Z-Score methodology is used to quantify financial distress as follows:

$$Z= 0.012X1 + 0.014X2 + 0.033X3 + 0.006X4 + 0.999X5$$

Z-score threshold values: Z-Score 1.81 indicates financial suffering, 1.8 Z-Score 2.99 includes a grey region, and Z-Score > 2.99 indicates financial stability or absence of financial strain.Independent Variable.

3.4 Independent Variable

This study's independent variables are cash flow: the amount of cash in and out of a company during a specific period; profit: the result of income minus expenses and expenses in the financial statements; and the board of directors: the board that assists the agency issues in determining policies. Board of Commissioners: a board that monitors the implementation of company policies and institutional ownership: share ownership held by a particular agency.

3.5 Data analysis

The data analysis in this research is descriptive statistics and logistic regression including fit model, feasibility test, determinant coefficient test and classification table.

4. RESULTS AND DISCUSSIONS

4.1 Descriptive Statistical Analysis

Table 1
Descriptive Statistics Test Results (2015-2018)

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
CASH FLOW	88	-,3279	1,4937	,276428	,3206487
PROFIT	88	-,0442	,2615	,066514	,0554422
DD	88	1	16	5,15	2,954
DK	88	2	8	3,92	1,432
KI	88	,05	,92	,5606	,25543
FD	88	0	1	,93	,254
Valid N (listwise)	88				

4.2 Logistics Regression Analysis (Assessing Model Fit)

Table 2
Model Fit Test Results Model Block Number 0

Iteration History a,b,c			
Iteration		-2 Logs likelihood	Coefficients Constant
Step 0	1	49,525	1,727
	2	44,159	2,373
	3	43,811	2,592
	4	43,808	2,615
	5	43,808	2,615

Source: Results of data processing version of IBM SPSS Statistics 25

Table 3
Model Fit Test Results Model Block Number 1

Iteration History a,b,c,d								
			Coefficients					
Iteration		-2 Logs likelihood	Constant	CASH FLOW	PROFIT	DD	DK	KI
Step 1	1	43,687	3,222	-,220	-4,912	0.017	-,145	-1,116
	2	31,070	6,405	-,546	-10,855	,042	-,369	-3,037
	3	24,330	10,871	-,873	-18,489	,084	-,695	-6,203
	4	20,452	16,613	-1.095	-28,248	,125	-1.071	-10,323
	5	18,477	23,428	-1,258	-39,724	,135	-1,436	-15,303
	6	17,712	30,270	-1,319	-51,550	,128	-1,731	-20,542
	7	17,578	34,336	-1,304	-58,921	,121	-1,873	-23,778
	8	17.573	35,280	-1,288	-60,687	,116	-1,893	-24,580
	9	17.573	35,328	-1,287	-60,776	,116	-1,892	-24,625
	10	17.573	35,328	-1,287	-60,777	,116	-1,892	-24,625

Source: Results of data processing version of IBM SPSS Statistics 25

The -2 log-likelihood value has fallen to 26.235 (43.808-17.573), showing that the regression model is superior and the hypothesized model fits the data.

4.3 Feasibility Test (Hosmer & Lemeshow' Goodness of Fit Test)

Table 4
Feasibility Test Results (Hosmer and Lemeshow's Goodness of Fit Test)

Hosmer and Lemeshow Test			
Step	Chi-square	df	Sig.
1	,208	8	1,000

Source: Results of data processing version of IBM SPSS Statistics 25

Hosmer and Lemeshow's Goodness of Fit Test) value is 0.208 with a significance value of 1,000, indicating that a significance value of 1,000 > 0.05 shows that the model can predict the value of its observations or is acceptable since it matches the observation data.

4.4 Nagelkerke R Square

Table 5
Coefficient of Determination Test Results (Nagelkerke R Square)

Model Summary			
Step	-2 Logs likelihood	Cox & Snell R Square	Nagelkerke R Square
1	17.573a	,258	,657

Source: Results of data processing version of IBM SPSS Statistics 25

The value of Nagelkerke R Square is 0.657, indicating that Cash Flow, Profit, Board of Directors, Board of Commissioners, and Institutional Ownership have a 65.7% effect on the dependent variable of financial hardship. Other variables beyond the scope of the study, such as financial leverage, healthy development, size, and agency charges, account for the remaining 34.3%.

4.5 Classification Table

Table 6
Classification Table

Classification Table, b					
			Predicted		
			FD		
	Observed		0	1	Percentage Correct
Step 0	FD	0	0	6	,0
		1	0	82	100.0
	Overall Percentage				93.2

According to the following classification table, all 82 samples (100%) are projected to face financial difficulty. Similarly, as many as six samples (0%) did not experience financial trouble despite being projected to.

4.6 Logistics Regression

Table 7
Logistics Regression Test Results

Variables in the Equation							
		B	SE	Wald	df	Sig.	Exp(B)
Step 1a	CASH FLOW	-1,287	1,947	,437	1	,508	,276
	PROFIT	-60,777	29,718	4.182	1	.041	,000
	DD	,116	,406	,081	1	,776	1.123
	DK	-1,892	1.160	2,663	1	,103	,151
	KI	-24,625	12,161	4,100	1	.043	,000
	Constant	35,328	15,118	5,460	1	0.019	2201207577863323,500

Source: Results of data processing version of IBM SPSS Statistics 25

The regression model in this study can be written as follows: Ln Fin_DISTRESS = 35,328 – 1,287ARS_KAS – 60.777LABA + 0.116DD – 1.892DK – 24.625KI + 0.05. According to the logistic regression results, cash flow has a significant value of 0.508 > 0.05, showing that cash flow does not influence financial hardship. The findings of this study reveal that each company's cash flow is high and can pay off its debts without experiencing financial difficulties. According to the research of Santoso *et al.,* (2017), cash flow does not affect financial distress.

Profit has a negative regression coefficient of -60.777 and a significant value of 0.041, as determined by logistic regression. The score of 0.041 0.05 suggests that profit is detrimental to financial hardship. The findings of this study indicate that the company can successfully manage its assets to generate profits, reducing the likelihood of financial distress compared to Yustika's (2015) findings that profitability evaluated using return on assets exacerbates financial misery. The company's strong profitability demonstrates its ability to generate significant earnings, leading to a growth in assets and protecting it from financial difficulties. According to the logistic regression results, the board of directors has a significant value of 0.776 > 0.05, indicating that it does not affect financial distress. According to the findings of this study, the number of board directors required to examine choices about the company's financial concerns is manageable. Santoso *et al.,* (2017) did not find that the size of the board of directors exacerbates financial distress in their study.

Based on the logistic regression results, the significance value for the board of commissioners is 0.103 > 0.05, showing that the board does not affect financial distress. The results of this study imply that the supervision will be less effective the more commissioners there are. The research of Widyasaputri (2012) indicates that the board of commissioners has little effect on financial hardship situations. It cannot be demonstrated that the board of commissioners significantly impacts financial distress, regardless of its size.

Institutional Ownership has a significant value of 0.043 and a negative regression coefficient of -24.625, per the results of the logistic regression test. Demonstrates that institutional Ownership is detrimental to financial hardship. This study's results demonstrate that managers' performance is more closely monitored as institutional ownership increases.

According to Ayuningtias's (2013) research, institution Ownership exacerbates financial suffering. The more extensive institutional Ownership will induce a higher level of management performance oversight.

5. CONCLUSIONS AND SUGGESTIONS

Conclusions of this study are the variable Cash Flow does not affect financial distress, the profit variable exacerbates financial hardship, the Board of Directors variable does not affect financial distress, the Board of Commissioners variable does not affect financial distress, and the variable Institutional Ownership is detrimental to financial distress. Companies may request consideration from the Board of Directors regarding the company's financial status to maintain solid financial reports and prevent financial difficulty. Investors and creditors must pay close attention to the firm's financial health. Be discerning and cautious regarding the company's actual condition.

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