CHAPTER I

INTRODUCTION

1.1. Background of Study

Evolution, metamorphosis, and growth, are one of the most fundamental nature known to humankind. Such is applied to corporations or business establishments. The assumption that a company may prevail its operation in the foreseeable future is the essence of the going concern principle (Fenyves et al., 2015). However, such assumption may be broken should anything jeopardizes the safety of the company, such as the threat of discontinuation, liquidation, bankruptcy, or any other terms describing the end of a company's operational activities. Prior to the end, there will always be omen or signs leading to it. Nowadays, it is crucial to possess or even create uniqueness within an organization for the purpose of staying ahead of competitors, which will multiply as days go by (Safitri & Yuliana, 2021). In the world of corporation, losing to competitors means losing in market, which will stun growth and eventually forced to step away (Erikawati et al., 2024). Another thing in the corporate world is that bankruptcy does not happen instantly or spontaneously, rather there will be indicator. Being in a delicate or feeble state, is one of the indicator referred. Companies that have been suffering commercial loss, delay in shipments, pushing back bank payments, and dropping in product quality are categorized as indicators (Dini & Murtini, 2023). No questions needed, that recognizing financial distress is essential in maintaining smooth operation within organization.

Distress or difficulties, especially financially, is the indication of a company diving head first to the water, that is bankruptcy (Utama, 2023). Financial distress is failure of meeting financial obligations due to insufficient funds (Safitri & Yuliana, 2021). The inability of companies to fulfill scheduled payments, is defined as financial distress by (R. Yolanda & Mulyana, 2023).

Manufacturing companies make up significant portion of a country's economy. A few may even rely heavily on such companies (Kibe et al., 2023). Early in 2024, *Kompas*, one of Indonesia's newspaper media, published an article about household consumption being the top contributor of economic growth in 2023. Overall growth recorded by *Badan Pusat Statistik (BPS)* in 2023 was 5.05% and household consumption was responsible for the 2.55%, which is half of the overall growth (Yogatama, 2024). In November 2023, IDX issued a press release regarding the number of its listed companies, and it was reported that a total nine hundred companies (900) were listed. Of those nine hundred, 16.9% of those is the Consumer Cyclicals sector, with one hundred fifty-two companies (152). Placing second after that is the Consumer Non-Cyclicals, with one hundred twenty-two companies (Nurahmad, 2023).

One specific example from a manufacturing company under the Consumer Non-Cyclicals, was PT Sariwangi AEA, a rather big and quite successful tea company that revolutionized the tea industry for its practicality in preparing tea with the use of tea bag. In 2018, it was deemed bankrupt by Central Jakarta Commercial Court *(Pengadilan Niaga Jakarta Pusat)*. A study was conducted for the sole purpose of narrowing down the cause of bankruptcy. The study concluded that PT

Sariwangi AEA was too focused on expansion without proper preparation on future objectives, threats, commitment, customer feedback, and task complexity. Thus, the bankruptcy (Ramadhan et al., 2022).

The essence of identifying financial distress is for companies to prepare possible countermeasures in order to prevent crisis that could eventually lead to bankruptcy. Not only the companies which are benefited from detecting financial distress, but investors as well. Investors analyze a certain company before they come to a decision to engage in business activities with said companies (Sari & Diana, 2020). Furthermore, the fundamental purpose of an establishment, in general, is to contribute towards society and generating/maximizing profits (T. Hidayat et al., 2024). Ubiquity is the nature of corporations, and ubiquity implies competitions, competitions incite structural uniqueness, uniqueness breeds advantage or leverage, ultimately leverage invites profits.

Table 1.1 List of DER and Z-score

Company	Code	Year	DER	Z-Score
PT Akasha Wira International Tbk	ADES	2019	0.448	3.093
		2020	0.369	3.909
		2021	0.345	5.788
		2022	0.233	10.875
		2023	0.205	12.425
PT Sariguna Primatirta Tbk	CLEO	2019	0.625	9.342
		2020	0.465	10.448
		2021	0.346	11.847
		2022	0.481	8.941
		2023	0.516	8.737
PT Multi Bintang Indonesia Tbk	MLBI	2019	1.528	14.712
		2020	1.028	10.106
		2021	1.658	7.602
		2022	2.144	7.325
		2023	1.449	7.715
PT Tigaraksa Satria Tbk	TGKA	2019	1.152	7.952
		2020	1.103	7.817
		2021	0.933	7.756
		2022	1.043	6.573
		2023	1.075	6.114

Source: Author (2024)

Table 1.1 showcased a total of four companies' Debt to Equity ratio (DER) and Z-score for the period of five years (2019 – 2023), taken from the total observation. Two of which are displaying consistent correlation between DER and Z-score, whereas the other two do not.

ADES is one of the consistent, where the correlation shown is of the negative effect. That is, throughout the five-year period, DER kept on getting lower and Z-score went on the opposite direction. From 2019, when DER decreased from 44.8% to 36.9% in 2020, Z-score went up from 3.09 in 2019 to 3.91 in 2020. It is the same as any other year within ADES, such as when in 2022, DER decrease to 23.3% from 34.5%, resulting in an increase in Z-score to a staggering 10.88 from 5.89, which is almost twice as much for a 10-percent-decrease.

The other one being consistent is CLEO, where negative correlation is still displayed and more. Unlike from the last example, where it contained only one direction (i.e. DER increases as year goes by, or Z-score's), CLEO is packed with more variety than ADES did. For example, in 2020 and 2021, the year when DER was at 46.5% and 34.6%, respectively, Z-score exhibits an antagonistic relation that is 10.45 in 2020 and 11.85 in 2021. At this point, such situation and outcome had already been shown. Furthermore, DER went up to 48.1% in 2022, and Z-score was being antagonistic yet again, having decrease from 11.85 in 2021 to 8.94 in 2022.

Moving to the inconsistent part of the example, that is MLBI. A period of year from MLBI will showcase a correlation, and the other will show otherwise. It can be observed in 2019, 2020, 2022, and 2023. The movement of DER from 2019 to 2020 was at a decrease, 152.8% to 102.8% respectively, and decreasing in value was within Z-score, that is 14.71 in 2019 to 10.11 in 2020. If it was to follow from previous movements (ADES's and CLEO's), Z-score ought to have been more than 14.71 in 2020. Similarly, in 2022 and 2023, when DER was also at a decrease from 214.4% to 144.9% respectively, the movement of Z-score was of antagonistic (i.e. 7.32 in 2022 to 7.72 in 2023), which is not the parallel movement as it was in 2019 and 2020.

Lastly, TGKA had a 110.3% DER in 2020, dropped to 93.3% in 2021, and again went up to 104.3% in 2022. In the span of those three years, Z-score had shifted two times and in two different steps. From 2020 to 2021, z-score suffered from 7.81 to 7.75, respectively. And again in 2021 to 2022, z-score suffered from 7.75 to 6.57. From table 1.1, TGKA had an increasing DER from 2019 – 2021, and it had shown a parallel relation between z-score, but in 2021 – 2023 the relation shifted into antagonistic.

Different conclusion is probable when it comes to conducting research. Such occurrence is because different research may have used different data from different period, and different method of interpreting those data. Evidently, studies regarding financial distress are no less protected from such phenomenon, as there has been multiple conclusion on whether financial leverage affect companies' state of distress. Financial leverage has been proven or rather theorized to be negatively affect financial distress by many. (Simorangkir, 2020), (Putri & Arifin, 2021), (Octavia et al., 2021), (Diana & Yudiantoro, 2023), (J. Wijaya & Suhendah, 2023), (Dini & Murtini, 2023), (F. D. Wijaya et al., 2024), (Syavira et al., 2024), (Lestari & Fitranita, 2024), all came to the same conclusion, that is leverage had negative effect on financial distress, meaning that highly leveraged companies are more exposed to financial distress. On the contrary, (Arifin et al., 2021), (Lubis et al., 2023), and (Sihombing & Angela, 2024) concluded that the more leveraged a company is, the lesser the threat of financial distress. There are also studies by (Dirman, 2020) and (Arya & Suhendah, 2024), where financial distress is unaffected by how leveraged a company is.

There have been many variables involved, especially financial performance variables, in the selected past studies. However, none has had the combination of these five variables, which will be elucidated further in the coming chapters. Furthermore, studies beforehand had only focused on one main sector but not on the sub-sector. In this case, the author focuses on a more specific sub-sector.

Based on the background of study, the author is captivated to engage in an educational research titled, **"THE INFLUENCE OF FINANCIAL LEVERAGE TOWARDS FINANCIAL DISTRESS".**

1.2. Problem Formulation

Since there is only one main variable used in the research, the whole process towards the end will solely be focusing on:

1. Does Financial Leverage affect Financial Distress?

1.3. Objectives of the Research

The objective of the research will be to provide an answer to the question formulated in the latter, which is:

1. To determine the effect of Financial Leverage on Financial Distress.

1.4. Benefits of the Research

1.4.1. Theoretical Benefit

The research can be of use to broaden scholars' knowledge on financial distress and the Altman Z-score model of financial distress.

1.4.2. Practical Benefit

1. To provide insight on how to determine the classification of financial distress
2. To provide insight on the reading of the Altman Z-score model of financial distress, and
3. To serve as additional literature material for researchers yet to come

1.5. Problem Limitation

The research conducted by the author focused only on several financial performance indicators, the size of firms, and one sector of industry. Such constraint is needed for the lack of research time. Additionally, the linear regression model did not entirely pass the classical assumption test, therefore state of BLUE was not obtained. This could be because of the period of which the samples were taken from. The main purpose of this research is for the author to explain the correlation, if any, between leverage and financial distress, as such multiple linear regression model was used.