CHAPTER II
LITERATURE REVIEW

2.1. Theoretical Review

2.1.1. Agency Theory

Jensen & Meckling (1976) in agency theory explains the existence of an agency bond that an industry is a collection of contracts between principals as shareholders and agents as management. Management is a party contracted by shareholders to work for the benefit of shareholders. Therefore, management is given the power to make decisions in the best interests of shareholders (Dewi et al., 2019). Both principals and agents have different interests so that agency problems arise, namely information asymmetry. Information asymmetry is an inequality in the acquisition of information between the agent as the data presenter and the principal as the data user. The agency theory arises aims to strengthen the attitude of the organization globally by emphasizing the bond between managers as agents of the company, and shareholders as principal (Felix, 2017).

According to Adams (1996), in agency theory there is a solution to cases that arise between principals and agents. The existence of information asymmetry between the principal and the agent can cause miscommunication between the principal and the agent. The agent puts more detailed data because it participates directly in the implementation as well as all things related to the running of the company. But principals do not participate directly in management. Because agents have a lot of data on industry management, agents can use this data to their advantage.

With these individual goals, agents can cause problems for the company. The company's performance will be a pity. The company's poor performance will certainly have repercussions on the company's finances. When a company has poor performance in its management, the company can face financial distress. If the company cannot overcome agency problems, the company will face bankruptcy.

2.1.3. Signaling Theory

According to Spence (1973) (in Tsaqif &Agustiningsih, 2021) signaling theory is a signal given by management to deliver data on relevant financial statements, and is presented to external parties for decision making. According to Lo (2012) (in Putri & Kristanti, 2020) signaling theory explains as giving signals to users about the financial condition of the industry. Signaling theory is used to determine if financial statements are used to obtain positive signals or good news or negative signals or bad news (Wijayanti et al., 2021). The form of a signal in the form of information carried out by management in realizing the expectations of the owner.

This theory emphasizes signaling management in order to reduce information asymmetry by reviewing positive and negative signals from management to shareholders (Tsaqif & Agustiningsih, 2021). According to Khasanah et al. (2021), the information disclosed by the company is important because it can influence investment decisions not only for shareholders and investors, but also other business stakeholders such as creditors. This information is important for investors and business partners because it is basically data, representation or reflection of the condition of the industry's existence in the future, present and future and its consequences to the industry.

The bond between signaling theory and financial distress is that investors can view the increase in company debt as a positive signal because debt can be used to increase the operational pay of the industry or the company's business. However, the increase in debt must be offset by the increase in profits achieved. If the increase in debt is not offset by an increase in profits, the company wants to struggle to fulfill its obligations, which can cause financial distress and is mistaken for a negative signal for investors (Wijayanti et al., 2021).

2.1.4. Financial Distress

According to (Dewi et al., 2019) financial distress is a situation in which the company's operating cash flow is not sufficient to pay obligations at this time, for example, debt and interest expense, so the company is required to take corrective action. One of the signs of financial distress in a company is the continued decline

in profits until they lose money (A. K. Putri &Kristanti, 2020). According to Dewi et al. (2019), financial distress can be measured using financial statement analysis. The financial statements prepared at the time the company was established are a means of communication and accountability to all parties who invest in the company and entrust the management of their funds to the company, especially its owners (Asfali, 2019).

Analysis of signs of bankruptcy should be carried out to predict the occurrence of bankruptcy in the future. The factors causing bankruptcy according to Asfali (2019) are divided into two, namely external factors and internal factors. External factors such as economic conditions, political circumstances, and natural disasters. Internal factors such as company performance, company policy, and corporate culture.

According to Suryani Putri & NR (2020), there are three causes of financial distress, and name it the basic model of bankruptcy, namely the neoclassical model, the financial model, and the corporate governance model. The neoclassical model states that the cause of financial difficulties is due to improper distribution of resources, such as improper management in the distribution of assets for the operational activities of the enterprise. The financial model states that the financial structure of the company is not good, and the company will not last long due to the lack of ability to finance the operational activities of the company. The financial model uses ROA, ROE, EPS, profit margins, debt ratios, and so on to estimate financial difficulties. This Corporate Governance Model explains that bankruptcy occurs when assets are mixed and the financial structure is not managed properly. Such as managers who tend to waste company resources for personal gain.

2.1.5. Liquidity Ratio

According to Revita & Ariyati (2020), the liquidity ratio is a ratio used to measure a company's ability to meet short-term obligations. A liquid company has a good cash flow so it does not hesitate to fulfill all its obligations, including paying taxes by applicable regulations. D. E. Putri & Abbas (2021), argue that companies

that lack money do not comply with taxes, rather than paying taxes, the company's finances are intended to maintain the company's cash flow.

Revita & Ariyati (2020) stated that there are several analyses to measure liquidity ratios such as the Current Ratio, Quick Ratio, and Cash Ratio. The current ratio is a ratio used to measure a company's ability to meet its current obligations by using current assets owned by the company. The quick ratio is a ratio used to measure a company's ability to pay current liabilities by using current assets without the value of inventory owned by the company. Meanwhile, the cash ratio is a ratio to determine the difference or similarity between cash and cash equivalent current assets owned by the company with current liabilities. The meaning of cash equivalent current assets is assets that are easy to cash out, in this case, what is meant is a bank. This study will use the current ratio as a liquidity proxy because the current ratio calculation still includes inventory as part of current assets. Inventory can be used as a guarantee against possible losses arising from the business by realizing non-cash current assets into cash, namely by processing and then selling to generate income (Asfali, 2019).

If linked to signaling theory, companies that have a high level of liquidity will show positive signals in the form of information that is relevant to investors and creditors, because the company is believed to be in a position to be able to repay and manage short-term debt. Basically, investors also look at the liquidity of a company. If the company's liquidity level is high, the company can avoid the risk of financial distress, and investors will have full confidence that the investment in the company is correct (Wulandari & Jaeni, 2021).

2.1.6. Sales Growth

According to Putri & Kristanti (2020) sales growth is the ability of a company to maintain a competitive level in an industry. The sales growth ratio is used to project growth in the coming year and can reflect past investment successes (Wulandari & Jaeni, 2021). The increase in assets owned by the company can be reflected in the growth of the company. According to Asfali (2019), the higher the revenue growth of a company, the more successful the company is in carrying out

its strategy in terms of marketing and product sales. This means that the profit recognized by an entity as a result of changes in the elements of its financial statements, such as the presence of changes in sales achieved is quite large.

Companies with positive revenue growth indicate good company health and are more likely to avoid financial distress. Negative income growth, on the other hand, can consistently indicate financial distress (Khasanah et al., 2021). Therefore, higher sales growth increases the company's ability to achieve profits and keeps it away from financial distress.

2.1.7. Company Size

According to Tsaqif & Agustiningsih (2021) the size of the company can be categorized based on the company's total assets. There are four types of company sizes, which are measured based on net worth and total sales, namely micro, small, medium, and large enterprises (Putri & Kristanti, 2020). The size of the company can be based on the value of shares, sales, or the value of the entire assets of the company. Total assets are used as a proxy for the size of the company. This is because assets reflect the company's wealth at a certain point in time (Wijayanti et al., 2021). If the assets owned are bigger, then the larger the size of the company.

Companies that have a large size get an advantage to obtain funding sources. This is because large companies have the opportunity to survive in market competition and be able to fulfill all their obligations (Tsaqif & Agustiningsih, 2021). The larger the size of the company, the more it will benefit because by having large assets, the company will be able to diversify its business as a form of development of the company and can generate profits. This ability to generate higher profits makes companies that have a large size can anticipate the occurrence of financial distress.

2.2. Empirical Review

A review of previous studies was carried out to illustrate the extent to which the variables in this study have theoretical and empirical foundations. Therefore, the authors looked for previous research related to this research from academic journals

and domestic and foreign literature studies. The results of previous research reviews relevant to this study are as follows:

Table 2.1

Empirical Review

No.	Author (Year)	Object and Variable	Model or Methodology	Result
1.	Murni (2018)	Object: 73 manufacturing group companies listed on the Indonesia Stock Exchange. Variables: Company Size, Company Age, Current Ratio, Debt to Equity Ratio (DER), Return on Asset (ROA), Return on Equity (ROE), Net Profit Margin (NPM), Earning Per Share (EPS), Price Earnings Ratio (PER), Financial Distress	Multiple Linear Regression Analysis	The size of the company, current ratio, DER, ROE, EPS, and PER have an insignificant negative influence on the level of financial distress. Meanwhile, the age of the company has a positive but insignificant influence on the level of financial distress, and NPM has a significant positive influence on the level of financial distress.
2.	Ramadhan & Firmansyah (2022)	Object: 46 consumer goods industry companies listed on the Indonesia Stock Exchange. Variables: Earnings Management, Debt Policy, Financial Distress, Independent Commissioner (moderating variable)	Multiple Linear Regression Analysis	The results of this study indicate that earnings management has a negative effect on financial distress, while debt policy has a positive effect on financial distress. This study also finds that independent commissioners can attenuate the negative effect of earnings management on financial distress. Still, independent commissioners cannot have a moderating effect on the relationship between debt policy and financial distress.

3.	Nugroho & Firmansyah (2017)	Object: 87 manufacturing companies listed on the Indonesia Stock Exchange Variables: Financial Distress, Real Earnings Management, Corporate Governance and Tax Aggressiveness.	Multiple Linear Regression Analysis	The results of this study indicate that financial distress does not effect on tax aggressiveness. While from real earnings management variables, only through manipulation of sales as which affects positive significantly on tax aggressiveness. On the contrary, manipulation of the production and manipulation of discretionary expenses precisely give the opposite effect. In addition, corporate governance consists of the audit committee and the percentage of institutional ownership can reduce tax aggressiveness, meanwhile the third measure (the percentage of independent commissioners) shows the opposite result.
4.	Wijayanti, Miftah & Siswantini (2021)	Object: 27 retail companies listed on the Indonesia Stock Exchange Variables: Leverage, Profitability, Company Size.	Logistic Regression Analysis	The results showed that leverage and company size did not have an impact on financial distress, while profitability had a negative impact on financial distress.
5.	Wulandari & Jaeni (2021)	Object: 26 property and real estate companies listed on the Indonesia Stock Exchange Variables: Cooperative Cash Flow, Leverage, Liquidity, Operating Capacity, Profitability, Sales Growth, and Financial Distress	Multiple Linear Regression Analysis	The results of the F test show that the variables of operating cash flow, leverage, liquidity, operating capacity, profitability, and sales growth simultaneously affect financial distress. However, in hypothesis testing (t-test) the variables of operating

				cash flow, operating capacity, profitability, and sales growth did not affect financial distress, while the variables of leverage and liquidity had a significant and negative effect on financial distress.
6.	Putri & NR (2020)	Object: 19 retail companies listed on the Indonesia Stock Exchange Variables: Financial Ratios, Company Size, Agency Costs, and Financial Distress	Logistic Regression Data Analysis	The results showed that profitability and liquidity had a significant negative effect and leverage had a significant positive effect on financial distress, while company size and agency costs had no significant effect on financial distress
7.	Asfali (2019)	Object: 8 chemical sector manufacturing companies on the Indonesia Stock Exchange. Variables: Profitability, Liquidity, Leverage, Sales Activity and Growth, and Financial Distress	Multiple Linear Regression Analysis	The results of this study show that simultaneous return on assets (ROA), current ratio, debt-to-asset ratio, activity, and sales growth have a significant effect on financial distress, partially the current ratio has a positive and significant effect on financial distress in the chemical sector manufacturing companies on the Indonesia Stock Exchange.
8.	Tsaqif & Agustiningsih (2021)	Object: State-Owned Enterprises listed on the Indonesia Stock Exchange Variables: Financial Distress, Company Size, Profit Management, and Managerial Ownership (variable moderation)	Moderated Regression Analysis	Based on the results of statistical tests, it shows that partially, financial distress and the size of the company have a significant negative influence on profit management. Furthermore, financial distress moderated by managerial ownership has a significant negative

				influence on profit management, and the size of the company moderated by managerial ownership has a significant positive influence on profit management.
9.	Nurfajrina, Siregar & Saptono (2016)	Object: All agribusiness companies listed on the Indonesia Stock Exchange Variables: Financial Distress, Financial Ratios, Total Asset, Return on Asset (ROA), Total Asset Turn Over (TATO), and Working Capital to Total Assets (WC/TA)	Panel Data Regression	The results showed that financial ratios are EBITDA to total assets, ROE, and TATO have a significant positive effect on DSCR. However, DAR and WC/TA have no significant effect on DSCR.
10.	Putri & Kristanti (2020)	Object: 70 companies in the basic and chemical industry sector and the mining sector are listed on the Indonesia Stock Exchange Variables: Liquidity Ratio, Audit Committee, Sales Growth, Company Size, Institutional Ownership, Independent Commissioners, Board of Directors, and Managerial Ownership	Survival Analysis and Cox Proportion Hazard Model	The results showed that the liquidity ratio and the audit committee were able to affect financial distress. Sales growth, company size, institutional ownership, independent commissioners, board of directors, and managerial ownership do not affect financial distress.
11.	Fadlillah & Susilowati (2019)	Object: all manufacturing companies listed on the Indonesia Stock Exchange Variables: Liquidity, Leverage, Operating Capacity, Profitability, Firm Growth, and Financial Distress	Binary Logistic Regression Analysis	The results of this study show that the variables of liquidity, leverage, operating capacity, and profitability have a significant influence on the financial distress condition of manufacturing companies listed on the

					Indonesia Stock Exchange. Meanwhile, firm growth has no significant effect on the financial distress condition of manufacturing companies listed on the Indonesia Stock Exchange.

2.3. Conceptual Framework and Research Hypothesis

2.3.1. Relationship between Variables of Liquidity Ratio and Financial Distress

Revita & Ariyati (2020) argues that the liquidity ratio is a ratio used as a benchmark for a company's ability to meet its short-term obligations. A company with a high level of liquidity has the opportunity to fulfill all its obligations and has a good cash flow. This is in line with the opinion of Putri & Abbas (2021) which states that if the company has a low level of liquidity it tends to have poor cash flow so that the company's ability to meet obligations is lower and more willing to maintain the company's cash flow. Moreover, these statements are also supported by the empirical findings by Wulandari & Jaeni (2021), which revealed that the liquidity ratio has a positive effect, particularly on financial distress. Asfali (2019), Indarti (2020), Irwandi et al. (2019) and Pulungan et al. (2017) also argues that the liquidity ratio has an effect on financial distress.

Therefore, based on the explanation above, the first hypothesis from this research is formulated as:

H1: Liquidity Ratio and Financial Distress have a significant relationship.

2.3.2. Relationship between Variables of Sales Growth and Financial Distress

Wulandari & Jaeni (2021) states that sales growth is used to estimate sales growth in the coming year to see the percentage of investment success in the past. According Amanda & Tasman (2019) the growth ratio describes a company's ability to maintain its economic position amid the growth of its economy and

business sector. The increase in the company's assets can be seen from the sales growth of the company. If sales growth increases, a company's ability to generate profits will increase so that the company will avoid financial distress. If sales growth decreases, it will cause potential financial distress due to a decrease in sales from the company. Furthermore, it is also supported by the finding by Juhaeriah et al. (2021), Asfali (2019), Sopian & Rahayu (2017), Setyowati & Sari (2019) and A. C. Nugroho et al. (2022) who revealed that sales growth has a significant impact on financial distress.

Therefore, based on the explanation above, the second hypothesis from this research is formulated as:

**H2: Sales Growth and Financial Distress have a significant relationship.**

2.3.3. Relationship between Variables of Company Size and Financial Distress

According to Amanda & Tasman (2019) the size of a company can reflect the size or size of a company by showing the total assets, a number of sales, average sales, and total assets. If a company has large total assets, this will have many positive impacts on the company. The large size of the company can add attractiveness for investors to invest and provide credit to the company. Interested parties such as investors and creditors are more interested in investing their assets and providing credit to companies that have a large size because a company with large size will give rise to the perception that the company is stable and will remain sustainable (Putri & NR, 2020). This is also supported by the empirical finding by Tsaqif & Agustiningsih (2021), Christina & Bangun (2022), Syuhada et al. (2020), (Putri & Merkusiwati, 2014) and Gaos & Mudjiyanti (2021) who found that company size is associated with financial distress.

Therefore, based on the explanation above, the third hypothesis from this research is formulated as:

H3: Company size and financial distress have a significant relationship.

Based on the results of the theoretical and empirical studies that have been described in Figure 2.1. The conceptual framework proposed in this study is as follows:
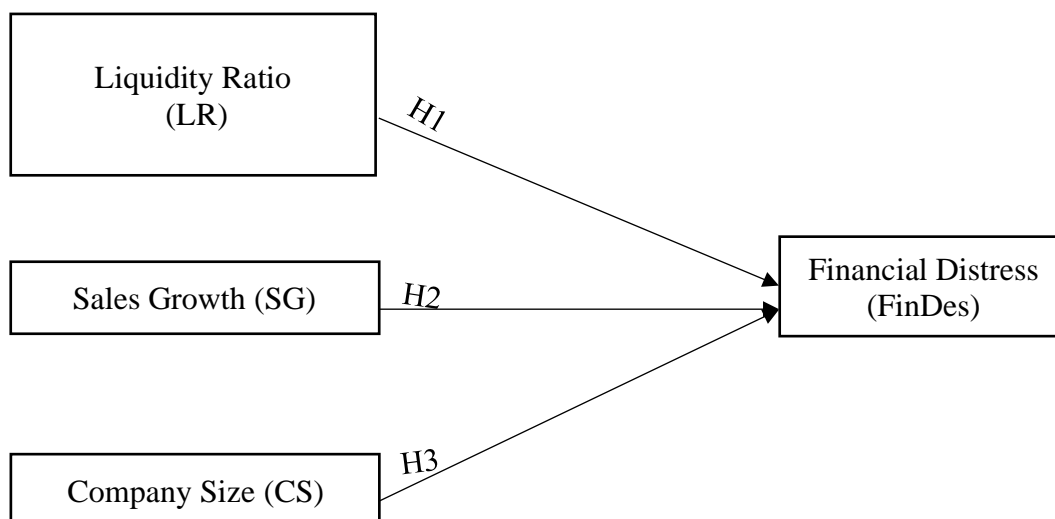
Figure 2.1 Conceptual Framework

Following previous research from Amanda & Tasman (2019), this study will take the liquidity ratio as an independent variable while modifying Sales Growth and Company Size into independent variables as well. The dependent variable used in this study is Financial Distress which is measured using the Altman Z-Score formula (1968). Financial Distress was measured by several models such as Zavgreen (1982), Ohlson (1980), Deakin (1977), Beaver (1966), and Altman (1968) which were later modified by Graham (1998). However, as stated by Nugroho & Firmansyah (2018) that the model developed by Altman (1968) and later modified by Graham (1998) has a high prediction rate above 60 percent and has also been used in various countries to estimate financial difficulties that will make a company bankrupt. Therefore, following previous research from Nugroho & Firmansyah (2018) which uses the Altman model (1968) later modified by Graham (1998) to measure dependent variables. The existence of the Altman Model (1968) is to predict the financial distress borne by a company with a higher level of prediction so that the test of the effect of Liquidity Ratio, Sales Growth and Company Size on Financial Distress will be more accurate.