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Capital Structure Analysis: Key Financial Indicators in Manufacturing

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ABSTRACT

This study focuses on how liquidity, asset composition, free cash flow, and profitability impact capital structure. It also explores how profitability can affect the relationship between liquidity, asset composition, and free cash flow with capital structure. The study focused on collecting information from 50 manufacturing firms that are publicly traded on the Indonesia Stock Exchange over a period of three years, totaling 121 data points. The data analysis method uses multiple linear regression with the help of the Statistical Package for Social Sciences program. The study's findings suggest that there is some evidence to support the idea that liquidity has a negative impact on capital structure. The asset structure variable and the free cash flow variable do not affect capital structure. The profitability variable is proven to strengthen the negative effect of liquidity on capital structure. Nevertheless, it is unable to enhance the favorable impact of the composition of assets and the detrimental impact of surplus cash flow on the firm's financial structure. According to the research, it is suggested that the board members and executives of the organization should be responsible for optimizing resources and driving up the company's earnings; investors who want to invest in manufacturing companies should do an investment assessment.

Keywords: Capital Structure, Profitability, Liquidity, Assets Structure, Free Cash Flow, Manufacturing Companies

1. Introduction

Capital structure is vital for any corporation as it can greatly impact the company's success either positively or negatively, where the problems faced by financial managers are the difficulty in determining factors for achieving an optimal capital structure. That means financial managers must create optimal capital by collecting funds from within and outside the company, which the goal is to reduce the amount of money the company needs to invest. When a company decides to take on debt, it incurs a cost of capital in the form of interest payments to creditors for external funding. This also results in an opportunity cost for using internally generated funds. There is a notable trend in the analysis of financial structure among manufacturing firms in Indonesia. It is a well-known fact that every company tends to have more debt relative to its capital in order to fund its day-to-day operations. Business risk positively impacts capital structure (Suryani & Sari, 2020). The capital structure significantly positively affects past debt, investment opportunity set, corporate tax, and profitability. A non-debt tax shield is a component that has minimal impact on capital structure, however, it has a detrimental effect on capital structure (Suryani & Sari, 2020). However, some studies show no significant effect (Hidayat & Sudarno, 2013). The fluctuations in the amount of debt over a long period can shed light on how manufacturing companies choose to finance their operations, thus leaning towards the static trade-off theory.

Manufacturing companies were chosen as the focus of the study due to their crucial role in continuously producing goods from raw materials, processing semi-finished materials, and preparing products for sale.

This process is overseen by the company's management team. The funds come from various sources such as cash flow, investments in assets, and the fixed assets that belong to the companies producing the product. Manufacturing firms require additional long-term financing options to support their strategic plans. One of them is profitability, namely how manufacturing companies can obtain profits/profits that aim for the company's survival, which is influenced by liquidity, free cash flow, and asset structure against capital structure. Profitability being a moderating variable is crucial because it plays a key role in demonstrating how a company can produce profits. Essentially, a higher profitability signifies a healthier and better performing company with a lower capital structure.

2. Literature Review

2.1. Agency theory

Management is an entity that shareholders engage with directly to serve the needs and goals of shareholders. Because they are elected, the company's management must be responsible for all their work and responsibilities to the shareholders (Jensen & Meckling, 1976). Agency relationships arise when one or multiple individuals (known as principals) hire someone else (referred to as an agent) to deliver a specific service and entrust them with decision-making power. The principal acts as a stakeholder or financier, while the agent serves as the manager of the organization. The core of the agency connection lies in the division of responsibilities between investors who own the company and the management who oversees its operations (Copeland & Weston, 1989; Maulana et al., 2024; Siahaan et al., 2024; Winarta et al., 2024).

2.2. Capital structure

The capital structure, or financial surrender, encompasses the enduring sources of funding such as long-term liabilities, preferred stocks, and shareholders' equity. This structure provides a framework for the company to conduct its daily operations (Kumari, 2021). An optimal capital structure is one that maximizes the company's value and share price. To make informed decisions, financial managers or the board of directors must carefully weigh the advantages and disadvantages of each funding source, as each has distinct financial consequences. Theoretical perspectives on financing include traditional methods, the Modigliani-Miller approach, Miller's model accounting for both corporate and personal taxes, pecking order theory, information asymmetry, and signaling theory. The pecking order theory, initially introduced by Donaldson (1961) and later named by Myers (2001), suggests a hierarchy in selecting funding sources: internal funding from retained earnings, followed by external funding starting with the least risky securities, then hybrid securities like convertible bonds and preferred stocks, and lastly, common stocks (Megginson, 2005).

Capital structure reflects the balance between long-term debt and equity (Riyanto, 2012). This study employs the debt-to-equity ratio formula to assess capital structure. The ratio includes current debt, non-current debt, and capital, which can be in the form of cash, shares, or assets, as indicated in the capital, surplus, and retained earnings sections of the company's income statement. Bhattacharyya and Morrill (2015) note that capital structure, comprising debt and equity ratios, is vital in corporate finance. The debt ratio, which is total debt divided by total assets, has a positive association with the inverse of total assets and a negative relationship with the logarithm of total assets divided by squared total assets.

2.3. Profitability

The organization's capacity to generate profits through its revenue and expenses recorded on the income statement, as well as how efficiently it utilizes its assets like machinery in production, determines its profitability (De Luca, 2018). Profitable companies do not need to pay the financial financing costs associated with debt. The company has strong enough retained earnings to fund the majority of its financial requirements (Barclay & Smith, 2005; Jonathan & Siahaan, 2023; Rakhmawati et al., 2024). In determining probability values, various ratio elements come into play such as return on assets, return on investment, return on equity, and asset turnover (Siahaan et al., 2023). This study uses the return on assets ratio to measure corporate profitability.

The profitability ratio serves as a gauge of how well the company's management is performing. A higher profitability indicates greater success, leading to increased prosperity for the company's shareholders.

Profitability can be measured in a few different ways. The gross profit margin assesses how well a company controls its cost of goods or production costs, indicating its efficiency in production. On the other hand, the net profit margin reflects the net profit remaining after taxes from sales. Return on investment, also known as return on assets, demonstrates how effectively management utilizes assets to generate income. This proportion indicates how effectively the company can make profits from the resources it employs. Understanding this metric can help assess whether the company is making efficient use of its assets in day-to-day operations. Return on equity is a measure of the company's capacity to generate profits that can be distributed to shareholders, or to gauge the value of returns provided for each unit of capital invested by the owner.

2.4. Liquidity and capital structure

The level of liquidity can be assessed by various measures, such as the current ratio, quick ratio, and cash ratio (Damayanti et al., 2022; Effendi & Siahaan, 2023; Purwanti, 2022). This study only uses the liquidity component because this method is commonly used by companies where liquidity can also measure the level of liquidity. Assessing a company's capacity to meet upcoming debt obligations, the current ratio serves as a useful benchmark. Despite a high current ratio, a company may still face difficulties in settling debts if the ratio is skewed by non-profitable assets like excessive inventory leading to low turnover rates and challenges in collecting receivables (Copeland & Weston, 1989).

Overall, companies with a lot of readily available cash usually avoid taking on debt for financing. This behavior is consistent with the pecking order theory, as companies with high levels of liquidity prefer to use their own funds for investments before turning to external sources like debt. Therefore, liquidity is inversely related to the debt equity ratio in a company's capital structure, with higher liquidity leading to lower levels of debt. Where a high level of liquidity indicates that the company's financial ratio performance is good and can meet its capital structure, the liquidity variable negatively affects the capital structure according to research by Akmalia (2022) and Data et al., (2019).

H_1: Liquidity is negatively associated with capital structure

2.5. Assets structure and capital structure

There are two main categories of assets: immediate assets such as stock, outstanding payments, and short-term investments, and long-term assets like intangible assets, physical assets, long-term debts, and the depreciation of tangible and intangible fixed assets (Mwaniki & Omagwa, 2017; Zadorozhnyi, 2018). The asset structure has excellent benefits for a company. The more fixed assets a company owns, the more external funding it can secure. This is due to the fact that a substantial amount of assets can serve as collateral. When the proportion of fixed assets in the asset composition is higher, the debt-to-equity ratio in the capital structure also increases. This is because the company's assets can be used as collateral for creditors to borrow debt, thus boosting the value of the debt-to-equity ratio. Therefore, a positive impact is observed when there is a shift from variable asset structure to capital structure.

The proportion of fixed assets to total assets is evaluated by asset structure. In industrial companies, the focus is on maximizing their own capital invested in fixed assets, with debt playing a supporting role. Based on Joni (2010) and Sahabuddin (2017), the opinion is that asset structure positively influences a company's capital structure.

H_2: Assets structure is positively associated with capital structure

2.6. Free cash flow and capital structure

According to the pecking order theory, a company's ability to make further investments is shown by its free cash flow, which prioritizes internal funds over debt to cover funding requirements. A company with a higher free cash flow is considered healthier as it has the resources for more investments, debt repayments, and dividend distributions (Frank et al., 2020). The company's debt equity ratio decreases as the free cash flow increases, as a higher cash flow enables the company to easily fulfill its debt obligations. This is because the company's internal cash reserves are enough to cover its debt payments, leading to a negative impact on the capital structure.

According to the findings of Dwi (2012), having excess free cash flow can impact the balance of the company's finances. This excess cash can be allocated towards investing in growth opportunities, paying off debts, or distributing dividends to investors. Free cash flow represents the surplus funding required for all projects with a positive return. Vogt and Vu, (2000) states that if there is extra cash left in the company after

expenses, it can be given to shareholders instead of being used for day-to-day operations or buying new assets. Any leftover cash should be used to pay off debts or give dividends to shareholders in the company.
H_3: Free cash flow is negatively associated with capital structure

2.7. The moderating role of profitability

Typically, companies with sufficient cash reserves do not rely on borrowing money; this behavior is supported by the pecking order theory. According to this theory, companies that are highly profitable and financially liquid have ample internal funds and prefer to use these funds to finance their investments before resorting to external borrowing. High profitability can offset the impact of liquidity on the capital structure, as profitable companies will have stronger liquidity due to their significant profits. This, in turn, may reduce the reliance on debt financing, as profitability can counterbalance the negative effects of liquidity on the company's overall capital structure. That is by research (Akhmadi, 2023; Thomas et al., 2014), which states the belief that being profitable can mitigate the adverse impact of liquidity on the capital structure.

Utilizing fixed assets for operational purposes will affect the profitability of the company by impacting its capital structure. The majority of the company's invested capital can be found in its fixed assets. In this case, if profitability is low, it will affect the contribution of the asset structure value to the capital structure. On the flip side, a company with a low return on assets may struggle to meet its debt obligations due to a weak asset structure. This could be attributed to fixed assets not being sufficient to support the debt equity ratio in the capital structure, ultimately leading to difficulty in making payments to creditors. So, profitability can weaken the positive influence of the asset structure on the company's capital structure. This is by Srimindarti et al. (2019), that profitability, when used as a moderating factor, has the potential to lessen the adverse impact of the asset composition on the financial framework.

A higher level of free cash flow within a company indicates better financial health, as it provides funds for additional investments, debt repayments, and dividends. When a company has substantial free cash flow, its debt-to-equity ratio tends to be lower because it can rely on internal cash resources rather than external debt. Additionally, if this free cash flow is supported by a high return on assets, it enhances the company's ability to manage its debt-to-equity ratio effectively. The profitability derived from fixed assets significantly contributes to the company's smooth operations and profit generation. Therefore, profitability can mitigate the negative impact of free cash flow on the capital structure. According Suastawan (2014), profitability acts as a moderating variable that can lessen the adverse effects of free cash flow on the capital structure.
H_4: Profitability can strengthen the negative influence of liquidity on the capital structure
H_5: Profitability can strengthen the positive influence of asset structure on the capital structure
H_6: Profitability can strengthen the negative influence of free cash flow on the capital structure

Figure 1 illustrates the conceptual model that depicts how liquidity, free cash flow, and asset structure affect capital structure, with profitability serving as a moderating variable. This model is grounded in established theories, concepts, and prior research.

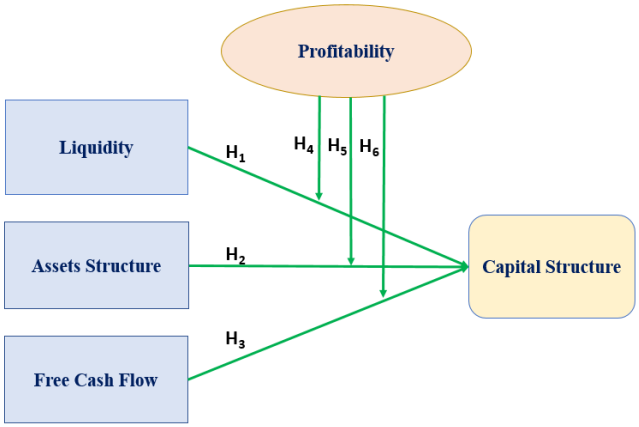

Figure 1. Conceptual model of the study

Source(s): Figure by authors

3. Methodology

This study employs a quantitative descriptive method and is designed as hypothesis-testing research. The unit of analysis is manufacturing companies, with data being quantitative and sourced from secondary data available on www.idx.co.id, focusing on manufacturing firms listed on the IDX. The dependent variable in this study is capital structure, measured using the debt-to-equity ratio, which is calculated as total debt divided by total capital (Riyanto, 2012). The independent variables in this study are liquidity, capital structure, and free cash flow. Liquidity is commonly measured using the current ratio, as it provides a more precise assessment of a company's liquidity compared to other liquidity ratios. The current ratio is calculated by dividing current assets by current liabilities (Syarifah, 2021). The asset structure represents the proportion of a company's total assets that are comprised of fixed assets. This ratio helps to understand how much of the company's resources are tied up in long-term, non-liquid assets (Copeland & Weston, 1989). Companies with substantial fixed assets often find it easier to secure external capital. The fixed asset ratio, calculated by dividing fixed assets by total assets, helps measure this. Free cash flow is determined using the formula: cash flow from operations minus capital expenditures, representing the cash available after the company meets its production capacity needs. The moderating variable in this study is profitability, which assesses the company's overall ability to generate profits relative to total assets by dividing profit after tax by total assets.

The research employs a ratio scale to measure variables. To gather data, financial statements of manufacturing companies are examined. Various sources including books, journals, and online resources are consulted to explore the factors that influence capital structure. The secondary data includes financial statements from 2014 to 2016 of manufacturing companies. Purposive sampling is used to target manufacturing companies listed on the Indonesia Stock Exchange (IDX) that have independently audited financial statements as of December 31. Only companies with positive net income are included to analyze the impact of independent variables, such as profitability, liquidity, free cash flow, and asset structure, on the capital structure. Data analysis is carried out using the panel data regression method, which combines time series and cross-sectional data. Descriptive statistics, classical assumption tests, and hypothesis testing are conducted using both Microsoft Excel and SPSS (Statistical Package for Social Sciences) software.

4. Results and Discussion

The outcomes of choosing samples through purposive sampling, where samples are picked based on specific criteria related to the study's goals, can be seen in Table 1. Initially, 150 samples were collected from companies on the Indonesia Stock Exchange. Yet, after filtering out unusual data points, the study ended up using a total of 121 samples.

Table 1. Sample Selection Procedure

Description	Amount
Manufacturing companies listed on the Indonesia Stock Exchange (IDX)	144
Manufacturing companies that did not announce financial statements and annual reports consecutively	-32
Manufacturing companies that reported losses in their financial statements	-47
Manufacturing companies that present their financial statements in foreign currencies	-15
Number of company samples in one period	50
Number of sample years	3
Number of samples during the study after outliers	121

Source: Data Processing Results

The following step involves examining the descriptive statistics, which are detailed in Table 2. PT Jaya Pari Steel Tbk has the lowest value for the capital structure variable, whereas PT Dwi Aneka Jaya Kemasindo

Tbk has the highest. On the other hand, PT Dwi Aneka Jaya Kemasindo Tbk has the lowest profitability variable value, while PT Indocement Tunggal Prakarsa Tbk has the highest. PT Kertas Basuki Rachmat Indonesia Tbk has the lowest liquidity variable value, while PT Jaya Pari Steel Tbk has the highest. PT Wijaya Karya Beton Tbk has the lowest value for the asset structure variable, whereas PT Lotte Chemical Titan Tbk has the highest. Lastly, PT Beton Jaya Manunggal Tbk has the lowest free cash flow variable value, while PT Indah Kiat Pulp & Paper Tbk has the highest.

Table 2. Descriptive statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Capital structure	121	0,04	2,88	0,9351	0,61235
Profitability	121	-0,24	0,18	0,0365	0,06851
Liquidity	121	0,36	464,98	7,0504	42,55650
Assets structure	121	0,05	2,02	0,8314	0,40274
Free cash flow	121	18,53	30,82	26,0324	2,17038

Source: Data processing results

Before conducting the regression test, classical assumption violations were checked. The Normality Test used the Kolmogorov-Smirnov analysis and the Normal P-P Plot Graph. The asymp.sig value of 0.000 (less than 0.05) indicated non-normal residuals, prompting an outlier test to remove extreme values. After this, the asymp.sig (2-tailed) value improved to 0.200 (greater than 0.05), indicating normal distribution, allowing the regression model to proceed.

The Multicollinearity Test revealed multicollinearity in the variables of liquidity, profitability, and their interaction, as the tolerance value was <0.10 or VIF >10. The Glejser Test showed no heteroscedasticity across all variables, with significance values >0.05. Autocorrelation was tested using Durbin Watson (D-W), with a result of 2.188, which fell within acceptable limits, confirming no autocorrelation.

The coefficient of determination (R^2) was 0.632, meaning the independent variables (liquidity, asset structure, free cash flow, profitability, and their interactions) explained 63.2% of the variation in capital structure, with 36.8% explained by other factors. The F-test (simultaneous test) showed a significant result, with F-count of 27.763 and a significance value of 0.000 (<0.05), indicating a joint influence of all independent variables on capital structure. The t-test (partial test) details are shown in Table 3.

Table 3. T-test results

Variabel	Koef.(β)	T	Sig.	
			(2-tailed)	(1-tailed)
Liquidity	-0,018	-5,98	0	0
Assets structure	0,097	0,92	0,359	0,179
Free cash flow	0,129	5,882	0	0
Profitability	30,367	3,72	0	0
Profitability * Liquidity	-0,826	-5,43	0	0
Profitability * Assets structure	-3,011	-1,66	0,1	0,05
Profitability * Free cash flow	-1,159	-3,73	0	0

Source: Data processing results

Liquidity negatively affects capital structure, as indicated by the acceptance of the H1 hypothesis in the t-test. According to the pecking order theory, a company's liquidity reflects its ability to meet short-term obligations using current assets. Companies with high liquidity gain more trust from creditors, allowing them to secure loans for growth, which can attract investors and boost company value. High liquidity also demonstrates a company's capability to repay short-term debts. With substantial retained earnings, companies often prefer to use internal funds rather than debt.

The pecking order theory suggests that managers prioritize internal funding over external (debt) financing. This study confirms that liquidity negatively impacts capital structure, meaning companies with high liquidity are less reliant on debt. As liquidity increases, companies tend to reduce long-term debt because they have sufficient internal funds to meet obligations and finance investments before turning to external debt sources. These findings are consistent with Infantri (2015) research, which also concluded that liquidity negatively affects a company's capital structure.

The composition of assets does not play a role in determining the financial structure, as shown by the refusal of the H2 hypothesis in the t-test. Asset structure measures the proportion of fixed assets compared to total assets. According to Riyanto (2012), companies in industries that require significant capital investments tend to prioritize internal funds, using debt as a supplementary financing option. The results of this study indicate that asset composition does not significantly impact financial structure, suggesting that having more fixed assets does not necessarily improve a company's ability to obtain financing due to the risk of losing those assets. Therefore, companies may still choose to rely on internal cash reserves rather than fixed assets to address their financial needs. These findings contradict the conclusions of Joni (2010) study, which suggested a positive correlation between asset composition and financial structure.

Free cash flow has no effect on capital structure, as shown by the rejection of the H3 hypothesis in the t-test. Free cash flow is extra money that can be used for investments, debt payments, or dividends. While it shows a company's financial flexibility, it is often given to shareholders instead of being used for operations or assets. According to the pecking order theory, companies use internal funds first. More free cash flow usually means a stronger company with money for investments, debt reduction, and dividends. However, this study found that free cash flow does not greatly impact capital structure. This suggests that extra free cash may not directly affect capital structure, as companies could face risks by investing it. In those cases, firms might use other resources, such as asset investments, to meet their capital needs. The findings of this research are not proven by the research of Dwi (2012), which state that free cash flow has a negative effect on capital structure.

Profitability can enhance the negative impact of liquidity on capital structure, as indicated by the acceptance of the H4 hypothesis in the t-test. According to Copeland and Weston (1989), companies with higher profit levels typically use less debt financing, relying more on retained earnings. This study finds that high profitability can strengthen the negative effect of liquidity on capital structure. Specifically, if a company's profitability is high, it supports liquidity in meeting short-term obligations to creditors. In other words, high liquidity, which reflects the company's ability to settle debts, is further bolstered by increased profitability, allowing the company to better manage its capital structure and reduce the debt-equity ratio. In this context, liquidity is measured by internal funding and asset investments, which impact the debt-equity ratio. For manufacturing companies, profitability linked to asset investments can mitigate risks associated with debt repayment.

Profitability does not enhance the positive effect of asset structure on capital structure, as shown by the rejection of hypothesis H5 in the t-test. According to Riyanto (2012), asset structure is defined by the ratio of fixed assets to total assets. In industrial companies, where a significant portion of capital is invested in fixed assets, debt is typically used as a supplementary source of funding. Asset structure includes current assets (cash, short-term investments, receivables, and deposits) and non-current assets (long-term investments, tangible fixed assets, and intangible fixed assets). This study finds that profitability does not strengthen the positive influence of asset structure on capital structure. This means that higher profitability does not necessarily improve the impact of asset structure on increasing capital structure. Instead, companies may rely on their fixed assets to meet capital requirements. As the asset structure (particularly tangible fixed assets) increases, the company may use these assets as collateral to fulfill its capital needs. Consequently, a higher asset structure could lead to a lower debt-equity ratio, as the company relies more on asset-backed funding and less on external debt.

Profitability does not amplify the negative effect of free cash flow on capital structure, as evidenced by the rejection of hypothesis H6 in the t-test. Free cash flow, which can be directed towards capital expenditures, debt payments, and dividends, indicates a company's flexibility in making additional investments. According to the pecking order theory, companies prefer using internal funds before resorting to debt. High free cash flow typically suggests a healthier company with funds available for investments, debt repayments, and dividends. However, free cash flow can also lead to conflicts between managers and shareholders, as outlined

by agency theory. This study finds that profitability does not enhance the negative impact of free cash flow on capital structure. In other words, increased profitability does not significantly alter the influence of free cash flow on capital structure. If a manufacturing company has high free cash flow, it is likely to use internal funds to meet debt obligations rather than increasing its debt. Additionally, financial managers need to avoid using company cash for unprofitable projects, which could deplete internal cash reserves. Increased internal cash from sales or receivables can improve free cash flow and help reduce the debt-equity ratio by allowing the company to pay off debts more effectively.

5. Conclusion

This research reveals that liquidity has a negative impact on a company's capital structure, indicating that companies must use their current assets to meet short-term obligations. In contrast, asset structure does not influence the capital structure. Fixed assets alone do not necessarily improve the capital structure (debt-equity ratio) due to the risk of asset loss, leading companies to rely more on internal cash and capital to meet their capital structure needs. Similarly, free cash flow does not affect the capital structure. High levels of free cash flow do not necessarily enhance the capital structure (debt-equity ratio), as there is a risk associated with adding free cash flow to capital. Companies may still face challenges if their internal cash is insufficient. Profitability, however, can strengthen the negative effect of liquidity on capital structure. High profitability supports liquidity, allowing companies to better manage short-term obligations and reduce the debt-equity ratio. On the other hand, profitability does not enhance the negative influence of asset structure on the capital structure. Increased profitability does not significantly impact how asset structure contributes to capital structure, as companies may continue to use fixed assets to meet capital needs. Similarly, profitability does not reinforce the negative effect of free cash flow on capital structure. Higher profitability does not significantly alter the impact of free cash flow on capital structure, as companies with substantial free cash flow may still prioritize internal funding to meet obligations rather than changing their capital structure.

The study's limitations include the outlier test, which makes the sample section less significant because several companies have abnormal analysis data, significantly influencing the research hypothesis. The managerial implications are that the company's commissioners and directors must manage the existing resources optimally to elevate the company's value and impact the company's profits. In addition, investors looking to invest in manufacturing companies should assess the company's financial health to determine if it is a good investment. This can be done by calculating financial ratios. The company must maximize its financial performance to generate profits by increasing profitability and its value. Further research should examine companies in different industries, such as trading companies and property industries. It can add the required variables such as company size, company growth, cost of financial distress, and non-debt tax shield.

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