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# Debt Policy, Liquidity Policy, and Profitability: A Proof from the Agricultural Companies in Indonesia

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## Abstract

Profits describe managers' performance in front of the company stakeholders, especially shareholders, suppliers, and creditors. Therefore, they must organize the financial resources well by taking exceptional policies. This research aims to know manager behavior to utilize debt and liquidity policies to create profits by examining their effect on profitability in the agricultural companies listed on the Indonesian capital market between 2014 and 2020 as the population and samples. Because of their homogeneous feature and the variables-related data, this study applies the simple random sampling method and the t-test for the coefficients in the regression model to prove each relationship. By Denoting these statistical testing results and their discussion, this study infers a negative relationship between debt policy and profitability. Conversely, the liquidity policy is positively associated with profitability. Therefore, we suggest managers use less debt and excess current assets, significantly cash, to enhance profits.

**Keywords:** Risk-Averse Managers, Ability of the Company to Result in Profits, Prospective Projects

## 1. Introduction

One of the Indonesian capital market sectors is agriculture (Hartono, 2017). In Indonesia, this sector is prospective because fifty-five million hectometers of agricultural land support it. This land contains twenty-four million hectometers of temporary function, and t rest are used for permanent purposes (Quincieu, 2015). Thus, according to Tambunan (2014), this sector can guarantee the supply of related goods for Indonesians and diminish employment. By mentioning Sukirno (2016), to handle this employment, one of the ways that the associated companies conduct is by investment. The investment will increase if the government intervenes through the central bank by reducing the interest rate, for example. If the interest rate goes down, commercial banks will follow it. Therefore, the company will invest in its business using these bank loans.

Besides obtaining bank loans, the companies have alternatives to get funds for overcoming the investment issue, for instance, through the capital market (Husnan, 2015) by offering and selling their stocks initially to society (Sunariyah, 2011; Hartono, 2017). After that, all their actions attract the attention of public investors to transact the stocks in the secondary market (Sunariyah, 2011). One of their causes is the relevant information in the financial reports (Munfaqiroh, 2006), where the profits become its quality (Shan, 2015).

The reached profits show that managers successfully organize the company (Singh, Darwish, & Potocnik, 2016). Therefore, they carefully utilize the liabilities to keep their reputation. If managers use debt too much, the companies will be in danger. As the worst consequence, managers will lose their job if bankruptcy happens. Some researchers agreeing with this circumstance declare a negative association between debt policy and profitability (Utama & Muid, 2014; Al-Jafari & Al-Salman, 2015; Filipovic & Demirovic, 2016; Masry, 2016; Petta & Tarigan, 2017; Nazir, Azam, & Khalid, 2021). However, this relationship is still not conclusive. In their study, Liargovas and Skandalis (2012), Prilianti et al. (2020), and Simionescu et al. (2021) show a positive sign. Meanwhile, Pratheepan (2014) displays no relationship between the debt-to-asset ratio and return on assets (ROA). Similarly, Samo and Murad (2019) cannot statistically associate the debt-to-equity ratio (DER) with ROA.

Besides debt policy, profitability is affected by how financial managers organize working capital in the company. If they can allocate funds to increase the fixed asset, the profits will upsurge. This allocation leads to low liquidity (Gitman & Zutter, 2012). Thus, a negative relationship between liquidity and profitability exists, as Liargovas & Skandalis (2012) demonstrate. Unfortunately, this result is arguable. Some researchers, like Utama and Muid (2014), Ali Alicia, Situmorang, and Alipudin (2017), Samo and Murad (2019), and Prilianti et al. (2020), prove a positive association. Meanwhile, Pratheepan (2014), Pervan, Pervan, and Ćurak (2019), Sahabuddin and Synthia (2020), Rajaguguk and Siagian (2021), and Simionescu et al. (2021) display no relationship.

After considering this opposing evidence, this study intends to examine the influence of debt and liquidity policy on profitability by applying the agricultural companies listed in the Indonesian capital market between 2014 and 2020 and company size as the control variables. Size utilization as a control variable follows the study of Đăng et al. (2020) and Simionescu et al. (2021). Academically, this study wants to strengthen previous studies with relevant logical explanations. Realistically, this study provides a way for managers to increase their profit based on the debt and liquidity policy.

## **2. Literature Review and Hypothesis Development**

### *2.1. The influence of debt policy on profitability*

Debt takes companies to face an increase in financial risk. If this situation happens, they must bear the increased interest expense (Gitman & Zutter, 2012). In the most horrible circumstance, they face technical and definitive insolvencies, where their profits cannot cover them (Hanafi, 2017). Therefore, managers of the company will become risk averters. They tend to use little debt to invest money in projects to avoid bankruptcy (Easterbrook, 1984). Therefore, a negative association between debt and profitability is expected. This explanation is supported by Utama & Muid (2014) and Petta and Tarigan (2017) after investigating the manufacturing companies listed on the Indonesian stock exchange. In their study, Al-Jafari & Al-Salman (2015) find this negative relationship once researching the companies in the Muscat capital market, Oman. Besides, Filipovic and Demirovic (2016) affirm this association when studying the firms listed in the capital market in Montenegro. Also, Masry (2016) locates this evidence after studying the firms in the capital market in Egypt.

Furthermore, Đăng et al. (2020) confirm this negative tendency of debt on profitability when researching companies shaping the S & P index in the United States. Also, through their study, Nazir et al. (2021) prove that short-term and long-term debt-to-total assets ratios negatively affect the profitability of the companies in the Pakistani capital market. By mentioning this information, the first hypothesis can be shaped like this.

H<sub>1</sub>: Debt policy affects profitability negatively.

## 2.2. *The influence of liquidity on profitability*

The high liquidity is indicated by the substantial cash and the account receivable but little current debt (Sanjaya, Sudirman, & Dewi, 2015). According to the trade-off concept in working capital management, a company with this condition cannot meet high profits (Gitman & Zutter, 2012). Unlike this perspective, Atmaja (2008) explains that if the company is liquid, the financial manager will utilize excess cash to buy goods from suppliers at a discount to get a low price. The company can compete with its rivalry to increase sales and profits if this action is effective. Thus, liquidity and profitability are expected to have a positive association. After investigating the manufacturing firms listed in the Indonesian capital market, Utama and Muid (2014), Alicia et al. (2017), as well as Prilianti et al. (2020) support this enlightenment: the company can be profitable despite high liquidity. By utilizing the current ratio and return on assets of the textile firms in Pakistan to measure liquidity and profitability, respectively, Samo and Murad (2019) support this explanation by showing similar evidence. By mentioning this information, the second hypothesis can be shaped like this.

H<sub>2</sub>: Liquidity affects profitability positively.

## 2.3. *The influence of company size on profitability*

Large firms do not depend on debt financing because of substantial retained earnings. As long as their retained earnings are sizeable, as the pecking order perspective declares, these firms tend to use these earnings to invest in risky projects (Brealey, Myers, & Allen, 2020). If the projects succeed, the shareholders will benefit (Easterbrook, 1984). Hence, a positive association between company size and profitability is expected. This enlightenment is confirmed by Pratheepan (2014) when researching the listed manufacturing companies in the Sri Lankan capital market. In their study, Al-Jafari and Al-Samman (2015) declare that firm size influences profitability positively after studying industrial companies on the stock exchange in Oman. Besides their research, this positive impact is supported by Masry (2016), when investigating the companies in the Egyptian stock market; Fareed, Ali, Shahzad, Nazir, and Ullah (2016), after studying the publicly listed enterprises in the power and energy sector in Pakistan. This similar evidence is also confirmed by Nazir et al. (2021), employing the companies in the Pakistani capital market's automobile, cement, and sugar divisions. By mentioning this information, the third hypothesis can be shaped like this.

H<sub>3</sub>: Company size affects profitability positively.

## 3. Methodology

### 3.1. *Research Variables*

The variables in this study cover the dependent and the independent. Profitability acts as the dependent, measured by the return on assets (ROA) at the end of the year. This measurement refers to Pratheepan (2014), Utama and Muid (2014), Al-Jafari and Al-Samman (2015), Filipovic and Demirovic (2016), Masry (2016), Alicia et al. (2017), Petta and Tarigan (2017), Đặng et al. (2020), Nazir et al. (2021), and Simionescu et al. (2021).

Meanwhile, financing policy, liquidity, and size are independent variables. Moreover, its measurement is depicted as follows.

- a. By indicating Pratheepan (2014), Utama and Muid (2014), Đặng et al. (2020), Nazir et al. (2021), Simionescu et al. (2021), we quantify financing policy by the debt-to-asset ratio (DAR) at the end of the year.
- b. By denoting Pratheepan (2014), Utama and Muid (2014), Al-Jafari and Al-Samman (2015), Alicia et al. (2017), and Simionescu et al. (2021), we quantify liquidity by the current ratio (CR) at the end of the year.
- c. By mentioning Pratheepan (2014), Al-Jafari and Al-Samman (2015), Masry (2016), and Nazir et al. (2021), we utilize the natural logarithm of total revenue at the end of the year to quantify the company size.

3.2. Population and Samples

The population in this study is the company in the agricultural sector in the Indonesian capital market. As for the time observation, we apply seven years, i.e., 2014 to 2020. Therefore, we found 16 consistent companies as the population size (PS). Furthermore, we use the Slovin formula with a border of error (be) of 10%, as mentioned by Suliyanto (2009) and shown in the first equation, to count the number of companies as the samples (n).

$$n = \frac{PS}{1+PS.be^2} \dots\dots\dots (1)$$

According to the Slovin formula, the samples needed are  $\frac{16}{1+16(10\%)(10\%)} = \frac{16}{1.16} = 13.79 \approx 14$  companies. After this size is known, we take the companies by employing simple random sampling and get their name: (1) Astra Agro Lestari (AALI), (2) Austindo Nusantara Jaya (ANJT), (3) BISI International (BISI), (4) Eagle High Plantations (BWPT), (5) Dharma Samudera Fishing (DSFI), (6) Dharma Satya Nusantara (DSNG), (7) Jaya Agra Wattie (JAWA), (8) London Sumatera Indonesia Plantation (LSIP), (9) Sampoerna Agro (SGRO), (10) Salim Ivomas Pratama (SIMP), (11) Sinar Mas Agro Resources and Tech (SMAR), (12) Sawit Sumbermas Sarana (SSMS), (13) Tunas Baru Lampung (TBLA), and (14) Bakrie Sumatera Plantations (UNSP).

3.3. Technique to analyze the data

By mentioning the variables defined, we utilize the regression model to analyze the data and the t-test to examine the statistical hypothesis. The model intended is in the second equation below.

$$ROA_{it} = \beta_0 + \beta_1DAR_{it} + \beta_2CR_{it} + \beta_3LN(REV)_{it} + \epsilon_{it} \dots\dots\dots (2)$$

The regression must pass some classical assumption tests to be an empirically good model. Hence, this model must achieve normality without multicollinearity, heteroskedasticity, and autocorrelation. Furthermore, to check them, we utilize the Jarque-Bera, White test with the cross term by variance inflation factor by mentioning Gujarati and Porter (2009) and runs by denoting Ghozali (2016) individually.

4. Result and Discussion

4.1. Result

The number of companies becoming the sample is 14, and the number of years is seven. Therefore, 98 observations are available. Furthermore, the outcome in this section is about four classical assumption tests, regression model estimation, and hypothesis examination.

4.1.1. The result of classical assumption tests

Figure one displays the probability of the Jarque-Bera statistic of 0.955810. This value is greater than the 5% significance level; hence, the residuals of the regression model are normally distributed.

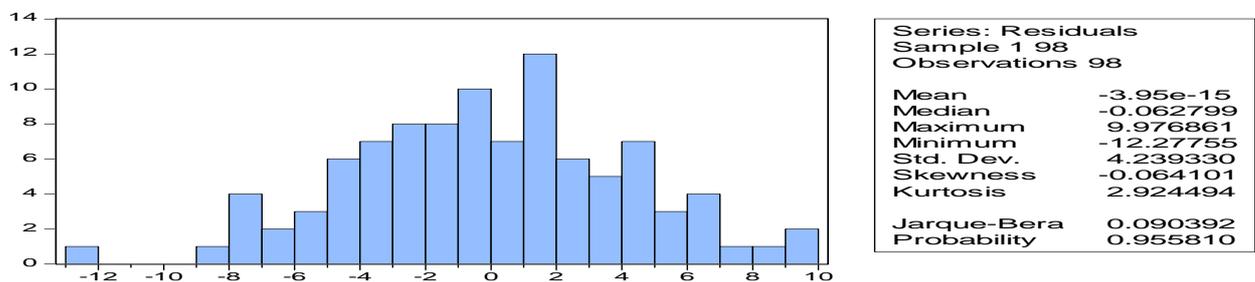


Figure 1: The Jarque-Bera test result  
Source: The output of E-Views 6

Table one consists of two panels. Panel A depicts the multicollinearity recognition result based on the variance inflation factor (VIF). Moreover, the VIF for DAR, CR, and LN(TA) is 1.487, 1.491, and 1.080. These values are lower than ten as the cut-off point. As a consequence, the model regression does not have a multicollinearity problem. Panel B exhibits the autocorrelation examination result utilizing the most prominent mode as the examined residual based on the runs test, with an asymptotic significance (2-tailed) of 0.000. Because this value is lower than the 5% significance level; therefore, the residuals are not random.

Table 1: The multicollinearity recognition and autocorrelation test results

Panel A: The multicollinearity recognition result			
Independent variable	DAR	CR	LN(REV)
Variance Inflation Factor	1.474	1.462	1.026
Panel B: The result of the average value-based runs test			
Description	Residual	Description	Residual
Test value	0.00000	Number of Runs	25
Cases < Test Value	50	Z-statistic	-5.075
Cases $\geq$ Test Value	48	Asymptotic Significance (2-tailed)	0.000
Total Cases	98		

Source: The output of IBM SPSS 19

Table two demonstrates the White heteroskedasticity test output with the cross-term. In this output, the probability of the t-statistic for DAR, DAR\*LN(REV) is 0.0039 and 0.0025, and these values are lower than the 5% significance level. Thus, variance residuals (RESID<sup>2</sup>) are influenced by DAR and its interaction with LN(REV). It means heteroskedasticity occurs in this regression model.

Table 2: The White test with the cross-term result:  
 $RESID^2 = f[DAR, DAR^2, DAR*CR, DAR*LN(REV), CR, CR^2, CR*LN(REV), LN(REV), LN(REV)^2]$

Variable	Coefficient	Std. Error	t-Statistic	Probability
C	-753.1708	389.3402	-1.934480	0.0563
DAR	744.6693	250.9448	2.967463	0.0039
DAR <sup>2</sup>	20.23793	19.72045	1.026241	0.3076
DAR*CR	0.111470	0.115240	0.967290	0.3360
DAR*LN(REV)	-49.85630	16.00526	-3.114996	0.0025
CR	1.057503	0.557982	1.895227	0.0613
CR <sup>2</sup>	-0.000155	0.000142	-1.097017	0.2756
CR*LN(REV)	-0.063375	0.033417	-1.896504	0.0612
LN(REV)	64.22777	45.56618	1.409549	0.1622
LN(REV) <sup>2</sup>	-0.960352	1.417748	-0.677379	0.4999

Source: The output of E-Views 6

#### 4.1.2. Regression model estimation and hypothesis examination

By mentioning Gujarati and Porter (2009), we utilize the Newey-West feature in the E-Views program. This feature handles heteroskedasticity and autocorrelation by making the standard error and covariance compatible. Furthermore, the intended model is available in Table 3.

Table 3: The regression model estimation result: The effect of financing policy, liquidity, and company size on profitability  
 Newey-West HAC Standard Errors & Covariance (lag truncation=3)

Variable	Coefficient	Std. Error	t-Statistic	Probability
C	-14.73156	6.534727	-2.254350	0.0265
DAR	-6.382910	2.899308	-2.201529	0.0301
CR	0.015457	0.004118	3.753279	0.0003

Table 3: The regression model estimation result: The effect of financing policy, liquidity, and company size on profitability

Newey-West HAC Standard Errors & Covariance (lag truncation=3)				
Variable	Coefficient	Std. Error	t-Statistic	Probability
LNREV	1.220495	0.413724	2.950023	0.0040

Source: The output of E-Views 6

In table 3, the probability of the t-statistic of the independent variables: DAR, CR, and LN(REV) of 0.0301, 0.0003, and 0.0040 exists. Because these values are below the 5% significance level, the sign of regression coefficients is statistically meaningful. It means that debt policy affects profitability negatively is acknowledged. Conversely, a positive effect of liquidity and company size exists.

#### 4.2. Discussion

The test result of the first hypothesis declares that debt decreases the capability of the company to create profits. This tendency happens because top managers are risk averters, utilizing less debt to invest in the projects to avoid bankruptcy. If bankruptcy happens, they will get lost their job and reputation. Therefore, this study supports the research conducted by Utama and Muid (2014) and Petta and Tarigan (2017), Al-Jafari and Al-Salman (2015), Filipovic and Demirovic (2016), Masry (2016), Đặng et al. (2020), and Nazir et al. (2021), declaring the negative relationship between the debt policy and profitability.

The test result of the second hypothesis declares that liquidity raises the capability of the company to create profits. This tendency means that the managers effectively utilize their liquid assets to get discounts when buying materials from suppliers. In the context of the agricultural industry, the suppliers consist of the sellers of (1) fertilizers and pesticides from the farming sector, (2) zooplankton and pellet from the fishing sector, and (3) the sellers of planted seeds from the forestry sector for instance. By considering the positive association, this study is in line with Utama and Muid (2014), Alicia et al. (2017), Prilianti et al. (2020), as well as Samo and Murad (2019).

The test result of the third hypothesis declares that size improves the capability of the company to create profits. This propensity means that the more extensive the firm is, the higher its retained earnings position to be reinvested in the project to result in profits. Hence, this study confirms Al-Jafari and Al-Samman (2015), Masry (2016), Nazir et al. (2021), and Fareed et al. (2016), finding a positive influence of firm size on profitability. Based on this significant effect; hence, the company size can effectively control the meaningful impact of debt and liquidity policies on profitability in this study context.

By mentioning the results of this research, it is suggested that the managers reduce the debt to create a safe condition for firms to operate in their business and utilize the excess cash to purchase the related materials from suppliers to get a discount. The discount can reduce the operating cost. Therefore, the firms can still survive and compete with their other companies by selling the products at the same price to their customers without loss of revenue part.

#### 5. Conclusion

This study intends to investigate the debt and liquidity policies conducted by managers in the agricultural companies listed on the Indonesian stock exchange and their effect on profitability by employing the size to control the consequence of these policies. Furthermore, this study uses seven years, from 2014 and 2020. Once examining three planned hypotheses and deliberating the results, this study deduces that the debt policy negatively influences the ability of the firm to result in profit. However, the liquidity policy positively affects this ability. Besides, the firm size as the control variable has the same tendency as the liquidity policy. With these empirical findings, this study effectively strengthens the related previous studies by providing relevant logical explanations.

Although successfully proving the proposed hypotheses, this study still has some boundaries, becoming the chance for succeeding scholars to improve. Firstly, this study only employs the agricultural companies listed in a single capital market as population and samples. Based on this situation, the scholars can combine the Indonesian firms

with the relevant companies in the countries producing agricultural products in Southeast Asia, such as Vietnam, Thailand, Malaysia, and the Philippines. Secondly, this study only utilizes three determinants of profitability. Based on this circumstance, the scholars can add the associated causing factors into their research models, such as working capital turnover, growth, asset structure, institutional ownership, company age, Herfindahl-Hirschman index, inflation, economic development, total assets turnover, effective tax rate, free cash flow, and board governance mechanism: board size, diversity, independence, meetings, tenure, and age.

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