

## ***The Effect of Corporate Governance, Leverage, and Firm Size on Financial Distress***

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### **ABSTRACT**

*This research aims to analyze the effect of corporate governance, leverage and firm size on financial distress. The population in this study was 652 consumer cyclicals and non-consumer cyclicals companies listed on the Indonesia Stock Exchange for the 2020-2023 period. This sample research used a purposive sampling method and obtained a sample of 163 companies. The research results show that Firm Size has significant negative effect on financial distress, Leverage and corporate governance have no effect on financial distress.*

**Keywords:** financial distress, corporate governance, leverage, and firm size.

### **ABSTRAK**

Penelitian ini bertujuan untuk menganalisis pengaruh tata kelola perusahaan, *leverage* dan ukuran perusahaan terhadap tekanan keuangan. Populasi dalam penelitian ini adalah 652 perusahaan *consumer cyclicals* dan *non-consumer cyclicals* yang terdaftar di Bursa Efek Indonesia periode 2020-2023. Sampel penelitian ini menggunakan metode *purposive sampling* dan diperoleh sampel dari 163 perusahaan. Hasil penelitian menunjukkan bahwa Ukuran Perusahaan memiliki efek negatif yang signifikan terhadap kesulitan keuangan, *Leverage* dan tata kelola perusahaan tidak berpengaruh pada kesulitan keuangan.

**Kata kunci:** kesulitan keuangan, tata kelola perusahaan, *leverage*, dan ukuran perusahaan.

### **INTRODUCTION**

In an increasingly competitive and dynamic business world, understanding financial distress is crucial for companies. Financial distress reflects the potential risks that may threaten the financial health of an organization. When companies face such challenges, the ability to detect and respond to financial problems early becomes a key factor in ensuring long-term sustainability. By monitoring financial ratios and other indicators, companies can identify potential financial issues at an early stage. For example, a decline in profit margins or an increase in debt ratios may signal that a company is on a risky path. Furthermore, monitoring working capital, total assets, and net profit is essential, as these three aspects are interrelated and contribute to a company's financial health. According to Hutabarat (2021), financial distress is seen as a stage of difficulty before bankruptcy. He states that not all companies experiencing financial distress will immediately go bankrupt. He categorizes financial distress into several levels of severity: Category A, which represents very high and hazardous financial distress with the potential for bankruptcy; Category B, which

represents high financial distress and is considered dangerous, requiring asset rescue measures; and Category C, which represents moderate financial distress. Recently, the Commercial Court at the Semarang District Court declared PT Pandanarum Kenangan Textil (Panamtex) bankrupt. Panamtex, a textile company based in Pekalongan, was established in 1994, specializing in the production of Sarung Tenun Binsaleh, Sarung Goyor, and Surban. Furthermore, it has been reported that seven textile factories in Indonesia closed in 2024, resulting in the termination of employment (layoffs) for 15,114 workers. The affected companies include PT Sampangan Duta Panca Sakti (Dupantex) in Central Java, which laid off 700 people; PT Alenatex in West Java, which laid off 700 people; PT Kusumahadi Santosa in Central Java, which laid off 500 people; PT Kusumaputra Santosa in Central Java, which laid off 400 people; PT Pamor Spinning Mills in Central Java, which laid off 700 people; PT Sai Apparel in Central Java, which laid off 8,000 people; and PT Sinar Panca Jaya in Central Java, which laid off 340 people (the most recent in August 2024). Additionally, there has been a trend of mass layoffs due to efficiency measures, including PT Sinar Pantja Djaja in Central Java, which laid off approximately 2,000 employees; PT Bitratex in Central Java, which laid off approximately 400 employees; PT Djohartex in Central Java, which laid off approximately 300 employees; and PT Pulomas in West Java, which laid off around 100 employees. Source: "Emeria: 7 Pabrik Tekstil RI Tutup di 2024-PHK 15.114, Ini Nama Perusahaannya" (CNBC Indonesia, 2024). In June 2024, the Indonesian Manufacturing Purchasing Managers' Index (PMI) fell to 50.7, down from 52.1 in May 2024. Although it remained in the expansion zone for 34 consecutive months, this figure is the lowest since May 2023 and marks the third consecutive decline. A significant rise in raw material costs contributed to this decline, which was further exacerbated by a 5.9% depreciation of the rupiah against the US dollar throughout the year. Conversely, decreased demand led to only a modest increase in product prices. Additionally, due to low purchasing power and limited global demand, demand in this sector is expected to decline in the coming year. With limited growth both domestically and internationally, Indonesia's manufacturing index is projected to range between 50 and 51 through the end of the quarter. Source: "Digital Strategy: Pertumbuhan Sektor Manufaktur Indonesia Melambat di Juni 2024" (Samuel Sekuritas Indonesia, 2024).



**Figure 1. Graph of Indonesia Manufacturing PMI**

Source: Samuel Sekuritas Indonesia, June 2024

In addition to pursuing financial profits, companies must pay attention to high-quality corporate governance in a dynamic business environment. Effective governance mechanisms are expected to minimize the risk of conflicts of interest, enhance transparency and accountability, and build trust among stakeholders. According to Lesmana and Damayanti (2021), independent commissioners overseeing the board of directors can help prevent financial problems. The board of directors holds the highest authority to make decisions and is responsible for managing the company to generate profits.

When facing financial distress, companies often become trapped in an unbroken debt cycle. They have limited cash flow and reduced financial flexibility due to heavy debt burdens. Changes in interest rates or unforeseen economic conditions can worsen the situation, burdening the business with debt costs and increasing the risk of default. Decisions to incur debt must be made cautiously and carefully, considering the company's financial condition, growth potential, and ability to manage the debt.

One important element that attracts the attention of stakeholders, such as creditors and investors, is the size of the company. According to Dirman (2020), company size refers to the total assets owned by a company. The smaller the value of a company's total assets, the fewer assets the company has to operate (Christella and Osesoga, 2019).

Research on financial distress has important implications in the field of accounting and for the stakeholders of a company. This financial distress examines the financial difficulties of companies in terms of governance implementation, debt levels, and firm size. The phenomenon is particularly interesting in this research, as Indonesia is facing a global economic crisis, marked by many companies struggling to survive. This has resulted in the closure of factories and layoffs conducted by these business entities, which not only affect thousands of workers who lose their livelihoods but also shake the national economy. This phenomenon serves as an alarm

for all of us to be more vigilant about the potential financial distress that can occur at any time.

This research refers to the research conducted by Manan and Hasnawati (2022) and Astrika et al. (2023). There is a research gap in the identification of financial distress in previous research, as most prior research focused on manufacturing companies. In contrast, this study uses a sample of consumer cyclical and consumer non-cyclical companies listed on the Indonesia Stock Exchange, with a sample period from 2020 to 2023. The researchers also use the Grover method (G-score) to test for financial distress. Another difference is the selection of variables used. This study includes the leverage variable. Additionally, the research incorporates the company firm size variable, which is believed to have an impact on the occurrence of financial distress.

The first variable is financial distress. The condition of financial distress in a company is defined as a situation where the company's operational results are insufficient to meet its obligations (insolvency). According to Emery et al. (2004), insolvency can be categorized into two types: Technical Insolvency and Bankruptcy Insolvency. Technical insolvency is temporary and arises when a company lacks cash to meet its short-term obligations. Bankruptcy insolvency is more serious and occurs when the total value of debt exceeds the total value of assets or when the company's equity is negative. Several factors can lead a company to face financial distress, including increased operational costs, excessive expansion, technological obsolescence, competitive conditions, economic conditions, managerial weaknesses, and a decline in industry trade activity (Wruck, 1990). Generally, mild financial distress is caused by management weaknesses within the operational cycle.

The second variable is corporate governance, which is definitively a system that regulates and controls the company to create value-added for all stakeholders (Monks, 2003). Two key aspects are emphasized in this concept: first, the importance of shareholders' rights to obtain accurate and timely information, and second, the company's obligation to disclose information about the company's performance, ownership, and stakeholders in an accurate, timely, and transparent manner. The Financial Services Authority (OJK) Regulation No. 57 of 2017 stipulates that securities companies listed on the Indonesia Stock Exchange must have independent commissioners. If the board of commissioners consists of more than two people, the percentage of independent commissioners must be at least 30% of the total board members. The composition of the board of commissioners must be arranged in such a way as to allow for effective and appropriate decision-making, in accordance with the General Guidelines for Good Corporate Governance (GCG) of Indonesia, published by the National Committee on Governance Policy (KNKG, 2006). However, the board of commissioners should not be involved in operational decision-making, as their role is to act as the company's supervisory board (KNKG, 2006).

The third variable is leverage, which is a ratio used to measure the extent to which a company's assets are financed by debt (Akuntansi et al., 2020). The level of debt refers to the financing through long-term debt. It indicates the company's ability to cover its long-term obligations. A high level of debt can result in a high debt burden, requiring the company to manage its debt effectively. A company that can manage its debt well can indirectly attract investors. This, in turn, can increase its stock market price. When the stock price rises, the company's value also increases, helping it avoid financial distress.

The fourth variable is firm size. According to Mahatma Dewi and Wirajaya (2023), firm size can be defined as an indicator used to measure the scale or capacity of a company. This size can be represented in various ways, such as total assets, total revenue, number of employees, or market value. According to the Indonesian National Standardization Agency (BSN), firm size in Indonesia is categorized into three types: large companies, which have net assets exceeding IDR 10,000,000,000 (ten billion rupiahs), including land and buildings, and annual sales exceeding IDR 50,000,000,000 (fifty billion rupiahs); medium-sized companies, which have net assets between IDR 1,000,000,000 (one billion rupiahs) and IDR 10,000,000,000 (ten billion rupiahs), including land and buildings, and annual sales between IDR 1,000,000,000 (one billion rupiahs) and less than IDR 50,000,000,000 (fifty billion rupiahs); and small companies, which have net assets up to IDR 200,000,000 (two hundred million rupiahs), including land and buildings, and annual sales of IDR 1,000,000,000 (one billion rupiahs).

## RESEARCH METHOD

The research method is a scientific approach to obtain data with specific objectives and uses (Sugiyono, 2021). Research methods involve several ways to collect data and achieve the expected results. This research design employs a quantitative method, aimed at testing the influence of independent variables. According to Mardawani (2020), research with a quantitative approach is a process of discovering knowledge through data in the form of numbers to analyze something that is being studied. The collected data is then analyzed using statistical techniques to describe the data and inferential analysis to make generalizations or conclusions based on sample data about the larger population. The units of analysis in this study are consumer cyclical and non-cyclical companies listed on the Indonesia Stock Exchange from 2020 to 2023. The research design is the framework for collecting, measuring, and analyzing data based on the research study problem. This research is conducted using hypothesis testing, examining the effect of corporate governance, leverage, and firm size on financial distress. The data collection technique in this research uses secondary data. The secondary data consists of the company's annual reports, information about the board members, and company management. This research data was obtained from the official website of the Indonesia Stock Exchange (IDX) at [www.idx.co.id](http://www.idx.co.id), as well as the related company websites to obtain

sustainability reports not available on the IDX website. Based on the criteria sample, the consumer cyclical and non-cyclical companies that were consistently listed on the IDX during the period from 2020 to 2023, with financial statement year-ends on December 31, 2020 to December 31, 2023, and that presented their financial statements in rupiah, were selected. After applying the selection criteria, 163 companies were identified, and with 4 years of data, 652 observations were obtained. The data collection method used in this research is the documentation method, which involves recording documents and other data related to the research. The analysis technique in this research uses panel data with Eviews software.

### Corporate Governance

The presence of an effective board of commissioners can enhance the transparency of financial reports and ensure that the information provided to shareholders is of high quality and easily accessible. The formula used to measure independent commissioners (IC) is as follows:

$$\text{Independent Commissioners} = \frac{\text{The number of Independent Commissioner} \times 100\%}{\text{The total number board of commissioners}}$$

### Leverage

This ratio measures the extent to which a company has borrowed from creditors. The higher the ratio, the greater the proportion of the company's funding that comes from external sources. In this research, the leverage is assessed using the Debt to Equity Ratio (DER), a ratio that compares the total debt with the amount of equity capital (owner's equity). The formula to calculate the Debt to Equity Ratio (DER) is as follows:

$$\text{DER} = \frac{\text{Total Debt}}{\text{Total Equity}} \times 100\%$$

### Firm Size

According to Susanto (2019), this research uses the natural logarithm of total assets as a measure of firm size. The purpose of using the natural logarithm is to simplify the value of total assets without altering the proportions or the actual value of the total assets. The formula for this variable is as follows:

$$\text{Size} = \ln (\text{total Company assets})$$

### Financial Distress

According to Awan & Diyani (2016), the Altman Z-Score is one of the models that can be used to assess financial distress. This model is preferred over others because it can be applied to various companies, including both manufacturing and non-manufacturing firms. Over time, the Altman model has been revised and modified

into different versions, such as the Grover model, which is an adaptation of the Altman model and analyzes data by applying the multiple discriminant analysis statistical technique (Permana et al., 2017). The Grover method was developed by Jeffrey S. Grover in 2001 using a sample of 70 companies. The sample consisted of 35 companies categorized as bankrupt and 35 other healthy companies from the period 1982 to 1996. The accuracy of the research, which reached 97.7 percent, indicates that the Grover model is effective for identifying financial distress in companies (Fahma & Setyaningsih, 2019). The company's market valuation, the ratio of retained earnings to total assets, and the ROA ratio are among the ratios that have been removed from the Grover approach, which represents an advancement of the Altman method. The G-Score is calculated using the formulas from the Grover model:

$$G\text{-Score} = 1,650X_1 + 3,404X_2 - 0,016X_3 + 0,057$$

Information:

X1 = Working capital on total assets

X2 = EBIT on total asset

X3 = Net profit on total assets (ROA)

There are three criteria used by the Grover method to categorize the calculation results (Asmaradana and Satyawana, 2022), which are:

Grover (G-Score) method, if the value of:

$G \leq -0,02$  = companies in financial distress

$G \geq 0,01$  = companies in healthy condition or safe zone

In this research, financial distress is represented using a dummy variable: 1 if the company is in financial distress and 0 if the company is in a healthy condition or safe zone.

### **The Effect of Corporate Governance on Financial Distress**

Organizations have a board responsible for overseeing and providing advice, which is implemented by the board of commissioners. With proper supervision, the board of directors can make the best decisions for the company. The agency theory was first introduced by Jensen and Meckling (1976). Agency theory is a contractual relationship between the principal and the agent, where the principal is the party that employs the agent to perform tasks for the principal's benefit, while the agent is the party that executes the principal's interests (Scott, 2015). Conflicts between the two parties occur when the agent seeks to maximize their own utility. Agency theory focuses on addressing two main issues in the principal-agent relationship, first, the problem that arises when the goals of the agent and principal differ, and second, the financial difficulties experienced by the principal in ensuring what the agent is actually doing (Eisenhardt, 1989). According to agency theory, effective and efficient

supervision by the board of commissioners over the board of directors or company managers can reduce agency costs due to agency conflicts. This means that there is a lower likelihood of an organization experiencing financial distress. Research by Manan and Hasna (2022), and Astrika et al. (2023) shows that there is a negative impact of the board size on financial distress. Soesetio (2023) found that governance does not have a direct or indirect effect on financial distress. Poor management is the primary cause of failure. Poor management is synonymous with poor governance. Characteristics of poor governance include rules coming from a single individual, a non-participatory board, leadership that cannot work as a team, a lack of understanding in company management, weak financials, and a combined CEO role.

H<sub>1</sub> : Independent Commissioner has a Negative Effect on Financial Distress

### **The Effect of Leverage on Financial Distress**

Financial distress occurs when a company is unable to meet its financial obligations as they come due, which, if left unresolved, may lead to bankruptcy. High interest rates can increase the burden of interest payments the company must make on its existing loans. If a company has a high level of debt, an increase in interest rates can exacerbate the financial strain on the company, thus raising the risk of financial distress, especially if the company's income is insufficient to cover the increasing interest payments. Signaling theory is based on the assumption that the information available to different parties is not the same. In other words, signaling theory deals with information asymmetry. It suggests that there is an imbalance of information between a company's management and the stakeholders who rely on that information (Ross, 1977). As a result, managers need to provide relevant and timely information to stakeholders through financial reporting. Signaling theory emphasizes how companies should send signals to financial statement users, providing information about what the management has done to fulfill the owners' objectives. Investors require complete, relevant, accurate, and timely information to make informed investment decisions. In addition to investors, creditors also need comprehensive information to assess whether they are willing to lend funds to a company. According to signaling theory, leverage can serve as a signal indicating a company's financial health. It is important for investors to understand how debt is being utilized and to carefully consider the signals a company sends through its financial structure before making investment decisions. Research conducted by Kurniasih et al. (2020), Atika et al. (2020), Isayas (2021), and Arifin et al. (2021) shows that leverage has a positive impact on financial distress, meaning that higher leverage increases the likelihood of a company experiencing financial difficulties. However, Oktavianti et al. (2020) and Azhar et al. (2021) find that leverage has a negative impact on financial distress, suggesting that in some cases, debt can help prevent financial distress. On the other hand, research by Arya and Suhendah (2024), Dirman (2020), and Sutra and Mais (2019) show that leverage does not have a significant effect on financial distress

H<sub>2</sub> : Leverage has a Positive Effect on Financial Distress

### The Effect of Firm Size on Financial Distress

Firm size is a consideration used to assess the scale of a company. The firm size can be measured based on various factors such as sales revenue, asset value, market capitalization, average asset size, average total sales, and so on (Gaol, R. L. & Duha, 2021). According to agency theory, a larger size may provide advantages, but it also brings significant challenges related to oversight, decision-making, and risk. Shareholders and stakeholders must be aware of these potential conflicts and risks to maintain the company's financial stability and ensure that management acts in alignment with their long-term interests. Research conducted by Arya and Suhendah (2024), Isayas (2021), Arifin et al. (2021), and Dirman (2020) shows that firm size has a negative effect on financial distress. However, researched by Purwaningsih and Safitri (2022), Christella and Osesoga (2020), and Oktavianti et al. (2020) indicate that firm size does not have an effect on financial distress.

H<sub>3</sub>: Firm Size Has a Negative Effect on Financial Distress.

## RESULT AND DISCUSSION

### Descriptive Test

Corporate governance, leverage, and firm size (independent variables), as well as financial distress (dependent variable), are the variables used in this research. A descriptive statistical analysis provides an overview of the standard deviation, mean, maximum, and minimum values of a data set. The descriptive statistical analysis for testing these variables is shown in the table below:

**Table 1. Descriptive Test**

	FD	DER	SIZE	IC
Mean	0.233129	1.392360	24.95376	0.431319
Median	0.000000	0.766855	26.79928	0.400000
Maximum	1.000000	190.3070	32.15770	1.000000
Minimum	0.000000	-598.4446	14.29851	0.290000
Std. Dev.	0.423148	25.98057	4.815190	0.104366
Observations	652	652	652	652

Source: Eviews 2024

Based on the data presented in Table 1 above, it can be seen that the minimum G-Score value in measuring Financial Distress (FD) in this study shows a minimum value of 0.000, indicating that the sample is not in financial distress, and a maximum value of 1.000, indicating that the sample is in financial distress, after conducting the descriptive statistical analysis. The mean value obtained is 0.233, while the standard deviation result is 0.423.

Corporate governance, measured by the Independent Commissioner (IC), resulted in a minimum value of 0.290 and a maximum value of 1.000 after the descriptive statistical analysis. The mean value was 0.431, while the standard deviation result was 0.104.

Next, leverage, measured by the Debt to Equity Ratio (DER), resulted in a minimum value of -598.445 and a maximum value of 190.307 after conducting the descriptive statistical analysis. The mean value was 1.392, while the standard deviation result was 25.981.

Lastly, firm size (Size) showed a minimum value of 14.299 and a maximum value of 32.158, with a mean of 24.954 and a standard deviation of 4.815. This indicates that, on average, companies in this study have high asset values because the average value is very close to the maximum value, with a mean of 24.954 and a maximum value of 32.158.

The t-test shows the results of whether there is an influence of the independent variables, which include the Independent Commissioner (IC), Debt to Equity Ratio (DER), and Size, either partially or individually, on Financial Distress (FD). Based on the processed data from Eviews, the following results are obtained:

**Table 2. Partial Significance Test (T test)**

	Prediction	Coefisient	Sig. One Tailed	Result
Consant		0.642314	0.0021	
DER	β+	9.69E-05	0.41465	Ditolak
SIZE	β-	-0.025165	0.00065	Diterima
IC	β+	0.506904	0.0529	Ditolak

Source: The result of data processing with Eviews 2024

$$FD = 0.642314 + 9.600005 \text{ DER} + (0.025165) \text{ SIZE} + 0.506904 \text{ IC} + e$$

**The Effect of Corporate Governance on Financial Distress**

The effect of Corporate Governance, as proxied by Independent Commissioner (IC), on Financial Distress (FD) based on table 2 above, shows that the Independent Commissioner (IC) variable has a coefficient value of 0.506904, which means that if IC increases by one unit, Financial Distress will increase by 0.506904. The significance value of IC is 0.0529, which indicates a significance level equal to 0.05. This implies that IC does not have a significant effect on Financial Distress. It can be concluded that the Independent Commissioner does not effect Financial Distress. The first hypothesis, H<sub>1</sub>, which states that the Independent Commissioner has a negative effect on financial distress, is rejected. The results of this research do not support agency theory, which suggests that independent commissioners in companies, as part of corporate governance, can reduce agency problems. This is because the presence of

independent commissioners in a company is believed to help reduce asymmetric information, which could otherwise trigger the company to be in financial distress. However, it seems that the existence of independent commissioners in companies in Indonesia is merely a standard set by companies to avoid penalties for non-compliance with regulations or established rules. The results of this research align with the research conducted by Novita and Rohmawati (2020) and Soesetio (2023), which state that good corporate governance, measured by the composition of independent commissioners, does not have an effect on financial distress.

### **The Effect Of Leverage on Financial Distress**

The effect of Leverage, as measured by the Debt to Equity Ratio (DER), on Financial Distress (FD) based on table 2 above reveals that the Debt to Equity Ratio (DER) variable has a coefficient value of 9.69E-05, indicating that an increase of 9.69E-05 in DER will result in an increase of 9.69E-05 in Financial Distress. The significance value of 0.41465 shows a significance level greater than 0.05 ( $0.41465 > 0.05$ ). This implies that Leverage does not have a significant effect on Financial Distress. It can be concluded that Leverage does not affect the Financial Distress. The second hypothesis, H<sub>2</sub>, which stated that leverage has a positive impact on financial distress, is rejected. The findings of this research do not support the signaling theory, which stated that the level of debt can signal whether a company is financially healthy or distressed. A company with high total debt is not necessarily in financial distress, and a company with low total debt is not necessarily in a safe position. A company with substantial debt may still have the ability to repay its debt and interest obligations, while a company with low debt does not guarantee the ability to meet its debt and interest obligations. This research are consistent with research conducted by Arya and Suhendah (2024), Dirman (2020), and Sutra and Mais (2019), which indicate that leverage does not influence financial distress.

### **The Effect of Firm Size on Financial Distress**

Based on table 2 above, it can be seen that the Size variable has a coefficient value of -0.025165, indicating that if Size decreases by -0.025165, the level of financial distress will decrease by -0.025165 units. The significance level of Size is 0.00065, which is less than 0.05 ( $0.00065 < 0.05$ ). This means that Size has an effect on Financial Distress. Based on the coefficient value, it can also be concluded that the direction of the result is negative. Therefore, it can be concluded that Size has a significant negative effect on Financial Distress. The third hypothesis, H<sub>3</sub>, which states that Size has a negative impact on financial distress, is accepted. Companies with a small firm size are more likely to experience financial distress due to being more vulnerable to external factors. This research are consistent with the research conducted by Arya and Suhendah (2024), Isayas (2021), Arifin et al. (2021), and Dirman (2020), which show that firm size has a negative effect on financial distress.

## CONCLUSION

Based on the results of the research and discussion, it was found that only one independent variable, firm size, has a significant negative effect on financial distress, while the independent variables of corporate governance (measured by the number of independent commissioners) and leverage do not have an impact on financial distress. However, this research has some limitations. First, the research only uses three independent variables corporate governance, leverage, and firm size. Additionally, the research only examines companies from the consumer cyclicals and non-consumer cyclicals sectors listed on the Indonesia Stock Exchange from 2020 to 2023. Suggestions for future research include adding other variables that may influence financial distress. Lastly, future research could consider companies from other sectors and extend the research period to obtain a broader comparison of results.

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