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Date: 6<sup>th</sup> of April 2020

Dear Arna Suryani

Lecturer at Faculty of Economics in Batanghari University, Jambi, Indonesia.

We glad to inform you that your research manuscript entitled "THE IMPACT OF FUNDING STRATEGY THROUGH THE FIRM SIZE ON PROFITABILITY" has been accepted for publication in Talent Development and Excellence Journal (Scopus Indexed Journal, Q2 ScimagoJR).

This letter is official confirmation of acceptance of your research paper.

Yours Sincerely,

**Jiannong Shi,**

Editorial Office

Talent Development and Excellence Journal



## **Journal of Talent Development and Excellence (JTDE)**

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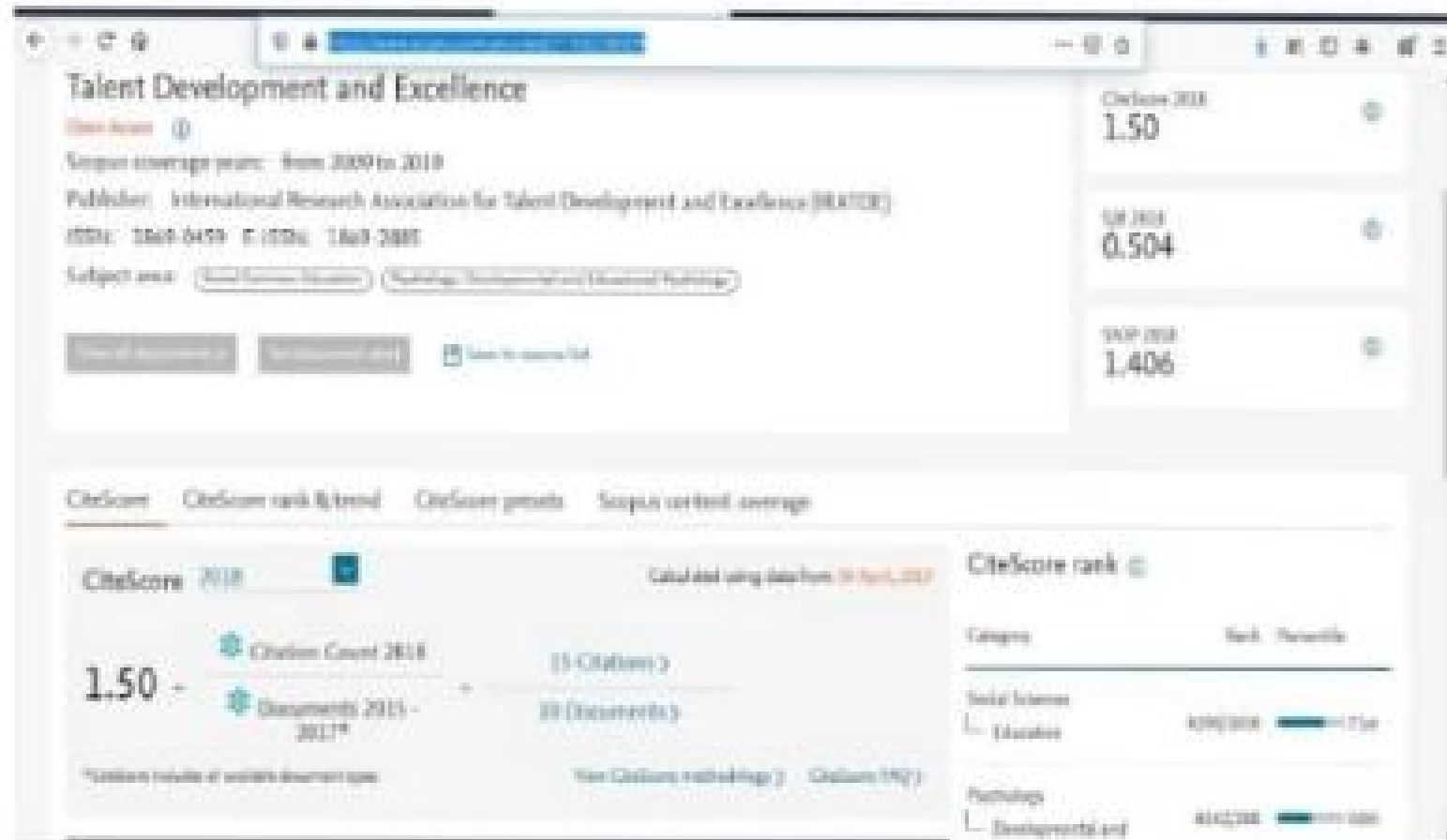
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Last updated January 8, 2017

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## The Impact of Funding Strategy Through the Firm Size On Profitability

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**Abstract:** This study aims to examine and analyze the impact of funding strategy through firm size on profitability. The funding strategy is measured by operating leverage and financial leverage, the firm size is measured by the Ln total assets of the firm, while profitability is measured by return on investment. The research sample is all of the LQ45 firms listed in Indonesia Stock Exchange in the 2014-2018 periods. The analytical method is descriptive verification analysis, data analysis by using path analysis with the hypothesis testing F and t. Based on the result of the research was found that the funding strategy simultaneously affect toward the firm size, while the profitability has no significant effect. Partially, only the financial leverage has the significant effect on the firm size by giving a negative influence direction of 0.505, while on the profitability of funding strategy does not have a significant effect. But, the firm size has a significant effect on the profitability. These results also prove that the funding strategy if through the firm size gives effect to the profitability with a total effect about 2.99%. The results of this research indicate that the funding strategy can affect into the profitability if through the firm size. The funding strategy can be used as one of the basic considerations for decision making in the financial sector, especially to maximize the corporate profitability.

**Key Words:** *Operating Leverage, Financial Leverage, Firm Size, Profitability*

### INTRODUCTION

The purpose of the establishment of a firm is to improve the prosperity of the owners of the firm through the process of maximizing its profits. The success of a firm is not determined merely by the amount of income obtained or generated by it, but it is also now connected to the amount of capital used to acquire the income in question. The issue of profitability of the firm in is more important than the issue of profit, because profit is a great course not necessarily prove that the firm size has been working effectively and efficiently. Efficient can be known by comparing such profits or calculating the level of profitability. Thus, it must be considered that firms are not only how the effort to enlarge the profit, but more importantly to increase profitability. For the firm in general, effort is directed to get the point of the profitability of the maximum of the maximum profit. The higher profitability of the firm will reflect the increasingly high level of firm's efficiency. The firm requires the presence of asset management, expenses, and debt to run their business optimally in order to increase profitability. Management must be able to know what factors that can affect the firm's profitability. Some of the factors that can affect the high and the low profitability of the firm are debt, asset, working capital, sales, and cost. Every firm certainly wants to get high profitability, but the great firm is certainly want a higher level of profitability compared to small firms (Hansen and Juniarti 2014). This is because the larger the size of a firm the greater the capital that one planted on various types of business, and more easily enter the capital market, obtain the high credit ratings are and so on, and will certainly affect the existence of total assets. Therefore, in conducting its business the firm requires substantial funds to each of the activities and needs of the operations can be run well.

Financial leverage is the practice of funding as the firm's assets with securities that bear the burden of a fixed return with the expectation of increasing the return end of for the shareholders (Arthur J. Keown, 2015). Leverage can be measured by operating leverage and financial leverage. Operating leverage arises due to the presence of fixed operating cost that are used in firms to get income, and financial leverage arises due to the presence of fixed financial charges to be incurred by the firm. The use of the leverage ratio with the aim that the profit earned is greater than the cost of the asset and the source of the funds, thus will increase the profit of shareholders. Fahmi (2013) suggested that the leverage Ratio is a measure of how large the firm will finance with debt.

Some of the previous studies give different results on how the effect of leverage toward the firm size and profitability. Niresh and Velnampy (2014) research proves that the firm's size has a significant positive effect on profitability. The results of Srivasta, Naita (2014) research showed that the leverage has a negative effect on profitability but insignificant. Wabwile, et.al (2014) also proved that leverage has a negative effect on profitability but insignificant. Different results shown by Khush Bakht, Tayyaba (2013) which proves the leverage has a positive effect on profitability but does not give a significant effect. Patel. J.B (2014) also provided the results that leverage is measured by operating leverage and financial leverage has a positive effect on profitability (ROE) but not significant.

Based on the above description, the problem of this research are as follow: (1) How is the effect of the funding strategy as measured by the operating leverage and financial leverage against on the firm size and profitability, (2) How is the effect of the firm size on the profitability, and (3) How is the effect of the funding strategy as measured by the operating leverage and financial leverage through the firm size on the profitability. The purpose of this study is to test and analyze the effect of funding strategy which is measured by operating leverage and financial leverage simultaneously and partially to the value of the firm and on profitability, as well as to test whether the funding strategy through the firm size can be affect on the profitability.

## LITERATUR REVIEW

### Leverage

According to Sjahrial (2007), there are two kinds of leverage, namely operating leverage and financial leverage. Leverage can be interpreted as a funding strategy which is used for investment in improving production, and generating the ability of earnings to cover the interest expense and income taxes (Harmono, 2011). Policy leverage is one of the part of the policy of the funding company. In addition, the policy leverage also functions as a monitoring mechanism against the actions of the manager made in the management of the firm. The term of the leverage is commonly used to describe the ability of the firm to use assets or funds that have a fixed cost assets or funds to magnify the return for the owner of the firm. The firm that does not use debt has a rise in EBIT of same magnitude with the increase in EPS. Different with the firm that uses debt has increase in EBIT of the same magnitude with the increase of EPS (Keown et.al. 2010).



### **Operating leverage**

Operating leverage is how large the fixed costs used in the operation of a firm (Brigham and Houston, 2011). Operating leverage is the use of assets with fixed costs with the expectation that the revenue or receipts that generated by the users of assets will be sufficient to cover the fixed costs and variable costs, or in other words a way to measure the business risk of a firm. Fixed costs such as depreciation of buildings, the office equipment, the insurance costs and other costs arise from the use of management facilities. Fixed operating costs, incurred for the volume of sales can generate the revenue greater than the entire cost of operating the fixed and variable (Timothy and Joseph 2000). If a firm has a high operating leverage, then a little increase in sales can increase the percentage on the earnings before interest and tax, on the contrary, if the firm has a low operating leverage then the decrease in sales will cause a decrease in the amount of earnings before interest and tax that is not proportional.

### **Financial leverage**

Financial leverage is used to measure how much the firm use the funding through debt (Brigham and Houston, 2011). Financial leverage is used to increase the change's effect in earning before interest and tax against on the Earning Per Share (Warsono, 2003). Financial leverage is occurs when a firm uses the sources of funds that provide a fixed load. The purpose of the use of financial leverage is to increase the return into the common shareholders. Financial leverage favorable happens if a firm can produce the revenues that received from the use of such funds is greater than the load remains to be paid. Regardless of the amount of income left over after fixed expenses are paid become the property of the common shareholders. Financial leverage is not favorable to occur when the firm has the revenue from the use of the funds is smaller than fixed expenses that must be paid. If interest is low, then the level of financial leverage will be low and if the interest is high, then the level of financial leverage will also be high (Utari et.al, 2014).

### **Firm size**

The firm size describes the size of the firm whether it is big or small. The firm size is the size of a firm is shown or judged by total assets, total sales, total profit, tax expenses and others (Brigham & Houston, 2011). The scale of the firm is the measure used to reflect the size of the firms based on the total assets of the firm (Suwito and Herawaty, 2005). Research of the firm size can use the benchmark asset, because the firm's total assets has the great value then this can be simplified by transforming into the natural logarithms (Ghozali, 2006). Scale the size of the firm is determined based on total sales, total assets, the average level of sales. A big firm has a lot of advantages compared to the small firm, such excess is the size of the firm can determine the level of firm ease to obtain funds from the capital market, firm size determines the bargaining power in the financial contract, and there is a possibility of the scale effect in the cost and return make a larger firm can gain more profit (Sawir, 2004).

## Profitability

Profitability is also called profitability is firm's ability to profit through all the capabilities, and existing resources such as sales activities, cash, capital, number of employees, number of branches and so on (Harahap, 2005). Profitability ratio is the ratio used to assess the ability of the firm in the search for profit. This ratio also provides a measure of the level of effectiveness of the management of a firm. This is indicated by the profit generated from the sales and investment income. The use of profitability ratios can be done by comparison between the various components of the existing reported financial data, especially the balance sheet and income statement (Cashmere, 2015).

## RESEARCH METHODS

The object of this research is the LQ45 index firm on the Indonesia Stock Exchange which publishes the annual auditor's financial statements in 2014 - 2018. This research uses a quantitative approach and the type of data used is secondary data. The sample selection is done by using a purposive sampling method with certain criteria. The sample chosen was 18 firms that consistently joined the LQ45 index for five years in a row. Data analysis was performed by using path analysis to test the contribution shown by the path coefficient on each path diagram of the causal relationship between the operating leverage and financial leverage variables on the firm size and its impact on profitability. Classical assumptions were tested for normality and linearity, and hypothesis testing F and t was performed with  $\alpha = 5\%$ . Operational Variables used are as follows.

**Table 1. Operational Variable**

Variabl	Definition	Formula	Scale
Operating Leverage (X <sub>1</sub> )	Degree of Operating Leverage (DOL) is the relationship between the firm's level of production volume and the rate of change in net income (Hendra, 2003).	$DOL = \frac{\% Ebit Change}{\% Sale's Change}$	Ratio
Financial Leverage (X <sub>2</sub> )	Financial leverage is the practice of funding as assets of firms with securities that bear the burden of fixed returns in the hope of increasing final returns for shareholders. (Arthur J. Keown, 2015)	$DFL = \frac{\% Eps Change}{\% Ebit Change}$	Ratio
Profitability (Y)	Profitability is the firm's ability to get profits through all capabilities, and existing sources such as sales, cash, capital, number of employees, number of branches and so on. (Harahap, 2005)	$ROI = \frac{Net Profit After Tax}{Total Asset} \times 100\%$	Ratio
Firm Size (Z)	The firm size is defined as a determinant of the size, dimensions, or capacity of a firm, as a determinant of large, or small firms can be seen from the total value of assets, net sales, and market capitalization. (Sawir, 2004)	Ln Firm Total Asset	Ratio

### Hypothesis

- H<sub>1</sub>: Operating Leverage and Financial Leverage simultaneously have a significant effect on Firm Size.
- H<sub>2</sub>: Operating Leverage partially has a significant effect on Firm Size.
- H<sub>3</sub>: Financial Leverage partially has a significant effect on Firm Size.
- H<sub>4</sub>: Operating leverage and financial leverage simultaneously have a significant effect on profitability.
- H<sub>5</sub>: Operating leverage partially has a significant effect on profitability.
- H<sub>6</sub>: Financial leverage partially has a significant effect on profitability.
- H<sub>7</sub> : Firm size has a significant effect on profitability
- H<sub>8</sub> : Operating leverage and financial leverage through the firm size have a significant effect on profitability

### FINDING AND DISCUSSION

Statistical test results are based on the normality test, the data used are normally distributed, and the linearity test results are judged from the deviation from linearity compared to  $\alpha = 0.05$ , independent operating leverage, financial leverage, and firm size data on the dependent variable, profitability is linear, so that the data is feasible to use. Path analysis is analyzed based on the path structure which is divided into 4 path structures. Analysis of the first path structure is to examine the effect of operating leverage and financial leverage variables simultaneously and in part on the firm size. The second path structure is looking at the effect of operating leverage and financial leverage on profitability. The third path structure is to see the effect of firm size on profitability and the fourth path structure is to see how the effect of operating leverage and financial leverage through the firm size on profitability. Following are the results of data processing to analyze the structure of the first path. It is the effect of operating leverage and financial leverage on the firm size simultaneously and in partially.

**Table 2. The Result of Path Analysis of Leverage Operating and Financial Leverage on Firm Size**  
ANOVA

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	5,094	2	3,047	3,744	,040 <sup>b</sup>
Residual	35,906	87	,814		
Total	41,000	89			

a. Dependent Variable: Firm Size

The table 1 above shows that the value of Sig. 0.040 < 0.05 then simultaneously between operating leverage variables, financial leverage has a significant effect on firm size. These results indicate that the firm can carry out a funding strategy with debt to fund it as the firm grows, in this case is its assets. The contribution of the independent variable operating leverage and financial leverage to the firm size variable is shown by R<sup>2</sup> of 25.4%. Simultaneously operating

leverage and financial leverage have a significant effect on firm value, so that the first hypothesis ( $H_1$ ) is accepted. Partially operating leverage variables, financial leverage with firm size variables can be seen in table 3 below.

**Table 3. The Results of the Path Coefficient of the Operating Leverage and Financial Leverage on Firm Size Coefficients<sup>a</sup>**

Model	Unstandardized Coefficients		Standardized Coefficients Beta	T	Sig.
	B	Std. Error			
(Constant)	-7,833E-018	,180			1,000
1 Zscore(DOL)	,012	,185	,012	,064	,950
Zscore(DFL)	-,505	,185	-,505	-2,731	,012

a. Dependent Variable: Firm Size (FZ)

Based on the 2 tables above, it is known that the variable operating leverage has a positive effect on the value of the firm by 0.012. These results indicate that operating leverage provides a positive effect sign, it means that the increase in operating leverage will illustrate the more great of a firm size, the more of the funding needs and the firm can carry out debt to fund it. So, debt will increase as the increases of the firm size. Judging from the level of significance it can be stated that operating leverage has no significant effect on the value of the firm which is indicated by a significance value of  $0.950 > 0.05$  then  $H_0$  is accepted and  $H_1$  is rejected, so the second hypothesis ( $H_2$ ) is rejected. Financial leverage variable has a negative effect on firm value of 0.505. These results illustrate that if the level of financial leverage increases, then this will reduce the firm size, because the firm size is based on the total assets. This is because if the firm is unable to pay the costs, so the assets owned can be an alternative financing to fulfill the firm's obligations. Based on the level of significance indicated by the significance value of  $0.012 < 0.05$ , it means that financial leverage has a significant effect on the firm value, so  $H_0$  is rejected so that the third hypothesis ( $H_3$ ) is accepted.

Testing the structure of the second path to test the effect of operating leverage and financial leverage on profitability simultaneously and partially can be seen in the following table.

**Table 4. The Results of Path Analysis of Leverage Operating and Financial Leverage Variable on Profitability ANOVA<sup>a</sup>**

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	3,497	2	,249	,233	,794 <sup>b</sup>
Residual	48,503	87	1,068		
Total	52,000	89			

a. Dependent Variable: profitabilitas

b. Predictors: (Constant), financial leverage (DFL), operating leverage (DOL)

From the results of simultaneous hypothesis testing between operating leverage and financial leverage variables on profitability variables with a significance value of  $0.794 > 0.05$ , it

can be stated that operating leverage and financial leverage simultaneously have no significant effect on profitability. Partially the effect of operating leverage and financial leverage variables on profitability has a positive but not significant effect. The results showed that operating leverage and financial leverage have a positive effect on profitability because the higher the burden borne by the firm illustrates the increased activity of the firm so that it can increase the profitability. Based on the significance level where  $> 0.05$ , so the fourth ( $H_4$ ) and fifth ( $H_5$ ) hypotheses are rejected.

Testing the third path structure is to see the effect of the firm size on profitability, obtained the following results.

**Tabel 5. The results of Path analysis of the Firm Size Variable on Profitability Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1,470E-017	,169		,000	1,000
	Zscore(FS)	-,564	,172	-,564	-3,272	,003

a. Dependent Variable: profitabilitas

From the table above it can be seen that the firm size has a negative effect on profitability of 0.564. These results prove that the size of the firm describes the firm size. The big firm usually have many assets. Large firm assets will give a signal that the firm has good prospects. Based on the significant level of  $0.003 < 0.05$ , the firm size has a significant effect on profitability so  $H_0$  is rejected, then hypothesis six ( $H_6$ ) is accepted.

The results of testing the fourth path structure to determine the effect of operating leverage, financial leverage through the firm size on profitability. It was found that the effect of operating leverage and financial leverage together through the firm size on profitability with a total effect of 2.99%, where the total direct effect was 1.51%, and the indirect effect was 1.48%. Based on the results of the statistical tests above, the firm size can be used as an intervening variable, thus jointly operating leverage variables, financial leverage through the firm size contribute on the profitability.

## CONCLUSION AND SUGESTION

Based on the results of the research, it can be concluded that the funding strategy as measured by Operating Leverage and Financial Leverage simultaneously has a significant effect on the Firm Size variables with a significance value of  $0.04 < 0.05$ . Operating Leverage directly affects the firm size by 0.014% and the indirect effect through financial leverage of 0.41%. Financial leverage directly affects the firm size by 26.0% and indirect effect through operating leverage of 0.41%. Simultaneously and partially, the funding strategy of the operating leverage and financial leverage have no significant effect on profitability. The firm size has a significant effect on profitability. Through the profitability of the operating leverage funding strategy and

financial leverage affect on profitability with a total effect of 2.99%. This proves that the firm size variables can mediate the operating leverage funding strategy and financial leverage variables on the profitability.

It is recommended for the firms to always manage their financial conditions that appear in financial ratios in financial statements, especially in the Degree of Financial Leverage and Degree of Operating Leverage that affect the firm's size and profitability. So that it can be used as one of the basic considerations in decision making in the financial sector, especially to maximize corporate profitability. For the next research, this research can be a reference material in conducting research, especially in the field of financial management and capital market financial accounting, it is recommended to look back on the financial conditions issued in the coming period.

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