

THE IMPACT OF FINANCIAL FLEXIBILITY ON LIQUIDITY WITH CAPITAL STRUCTURE AS THE INTERVENING VARIABLE

Arief Budiman¹, Muis Murtadho², Erna Ferrinadewi³

Economy, Widya Kartika University, Indonesia^{1,2,3}

E-mail: arief@widyakartika.ac.id¹

muis@widyakartika.ac.id²

ferrinadewi@gmail.com³

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ABSTRACT

Financial flexibility demonstrates the company's financial ability in handling uncertain situations, especially during the Covid-19 pandemic. The purpose of this study were to test and analyze the impact of financial flexibility towards the company's liquidity with capital structure as the intervening variable. Applying quantitative method, the study took samples from companies listed in the Indonesian Stock Exchange in the period of 2020 and 2021 during the Covid-19 pandemic and examined the impact towards company's liquidity. Results demonstrated that financial flexibility indeed influences company's liquidity; the flexibility, however proves to be insignificant to the capital structure.

Keywords: *Finacial Flexibility, Liquidity, Capital Structure*

JEL Classification: G3, H1, E6

INTRODUCTION

Financial flexibility demonstrates the company's ability in mobilizing its financial resources to take any necessary preventive action and utilization in order to respond any uncertain situation that may happen in the future in the most opportune time in an effort to maximize the company's valuation. Financial flexibility is crucial for the company management in the crisis situation such as the period of Covid-19 pandemic; a situation which practically devastates the foundations that may threaten the company's financial liquidity due to access shutdowns and limitations on company's operations, causing a huge decrease in product sales, resulting in a huge decrease in profit and company's liquidity.

Managerial skills are essential during the period of Covid-19 pandemic to maintain the company's cash flow. Financial flexibility is required in order to provide the capital needed as a funding alternative during the period of Covid-19 pandemic to maintain company's liquidity.

The flexibility in financial management is determined by the company's capital structure. The company would conduct a calculation on funding sources, either in the form of debts or stock. The company would also need to apply proper risk management to avoid imposing an excessive burden to the company in an attempt to ensure company's liquidity during the period of Covid-19 pandemic.

Ferrando, *et al* (2017) highlights that a higher financial flexibility would enable a company to reduce the negative impact on liquidity towards the investment. The study results confirm that financial flexibility increases the company ability for future investment, although market friction may contribute as a hindrance to any market growth.

Denis (2011) argued that financial flexibility should be the main focus of any corporate manager. The academician emphasized that the need of a company to maintain

its flexibility is an essential component in a company's financial policy. Current literatures support the notion that a company would achieve financial flexibility by managing company's liquidity, capital structure policy, and payment policy.

This study aimed at developing the model proposed by Ferrando (2017) and Denis (2011) in which financial flexibility influence the capital structure and company's liquidity. The study would reposition those two models by adding the risk management variable to reduce the risk of company default its liability.

Jagannathan *et. al.*, (2000) stated that stock buyback and dividend are to be used in different time, by different "rms. Stock buyback is more inclined to a certain cycle, while dividend tends to increase over time. A company pays a dividend more with a permanent operation of cash flow, while a stock buyback is used by a company with a more temporary and non-operational cash flow. The buyback "rms also has a more fluctuating cash flow and distribution. Thus, "rms buys back the stock if the stock shows poor performance and increases the dividend if the performance is good. This result confirms with the notion that accessibility of a buyback is one of the reasons it may be used to replace a dividend.

Marchica and Mura, (2010) argued Conservative leverage policy is aimed at maintaining financial flexibility to improve the ability to do investment. Analysis highlights that after a period of low leverage, a company would spend its capital to buy and increase the abnormal investment. This new investment seems to be funded by issuing a new debt. The impact of financial flexibility is significant statistically and substantial economically. A longterm test revealed that a company with more financial flexibility is not only investing more but also investing better. This is in line with the notion that financial flexibility in the form of loan reserves which is not utilized by the authority is the missing link in the theory of capital structure.

Caballero *et. al.*, (2016) argued that proper funding strategy would help the company improve its performance. Besides that, results showed that there is a change in the relationship between funding and performance during a financial crisis. It is found that this relationship depends on the company's financial flexibility. The interesting part is that a manager does not only have to concern himself on the investment on work capital funding, but also need to consider on how tis investment would be funded. This study found that how the funding strategy for the company's required work capital would influence its performance.

Hendrick (2002) highlighted a trend that a suburban area with a higher diversification increase tends to be leading, younger, having less housing complexes, having more growth, less dependent on property tax and depends more on sales tax. Model estimation showed that people with more income diversification tend to have less tax efforts when controlling other determinants from a tax effort. This effect is stronger in a non-housing city.

Gryko (2018) explains that financial flexibility is a very complex concept and multi-dimension, closely related to the company's flexibility. This study aims at finding financial flexibility in both the financial management of the company and within the strategy implementation. New definition of financial flexibility has been proposed by considering the flexibility dimension identified by the science of management and its complex relationship with organizational flexibility. Further study should involve the interconnection between factors forming flexibility.

Islam *et. al.*, (2019) investigated the financial flexibility on different theories to determine the triggering factor for it, including cash at hand, leverage position, financial difficulty, correlation between financial flexibility and the company's performance, off-balance sheet item impact, company's social responsibility on debt policy and financial flexibility as well as how to measure long term financial flexibility.

Powers and Tsyplakov (2008) found that options on corporate obligation, either it is call, make whole, put or conversion, requires benefit and cost for both the issuing and the obligation holder. In terms of call, the issuing company has the ability to call an

obligation if the economic situation changes significantly and call-in-the-money commission. Besides that, the company has a flexibility to call an obligation earlier if there is a specific situation requiring for that. Since the obligation holder lacks the buy option, a compensation in the form of incremental yield is required.

Andrea and Triantis, (2008) found that the value of funding flexibility depends on the cost of external funding, the tax rate of the company, and the individual who determines the effective cost of cash, the growth and maturity potentials of the company, and the capital reversibility. Simulations showed that a company having a funding friction must conduct borrowing and loaning simultaneously. The debt was then dynamic and the liquidity policy and value are related to the company's liquidity.

Bonaimé, *et. al.*, (2014) found that a more flexible distribution would motivate dividend buyback, negatively correlates with financial hedge of a company, consistent with financial flexibility in payment decision and hedge becomes the replacement. To properly control the endogenous variable due to hedge and payment choice, a payment is recommended to also offer an operational hedge value.

Vithessonthi (2010) found that financial flexibility positively connects to the change of an organization and that the structure of a financial system moderates the influence of financial flexibility towards the organizational change. Moreover, a company operating in a country with a bank-based financial system tends to conduct a strategic or organizational change at primary level, while a company operating in a country with a market-based financial system tends to conduct a strategic or organizational change at secondary level.

Vaez. *et. al.*, (2021) argued that flexibility could be viewed as the interconnection between local loans and overseas capacity. Using the internal fund accumulation enables the company to make a proper growth time choice competitively and conduct a project with a currently positive net value.

Hoberg *et. al.*, (2014) highlights that fluidity reduces the company's tendency to use dividends or buybacks as means of payment and increasing the company's cash at hand, especially for a company with more limited access to the financial market. This confirms the hypothesis that a company's financial policy is significantly formed by the threat and dynamics of a product market.

Liu (2017) found that financial flexibility is the key factor for company management. Academicians have proved that the demand for maintaining flexibility is the important determinant of a company's financial policy. Current literature elaborated that a company has financial flexibility through the low leverage policy and cash holding policy.

Kumar and Vergara-Alert (2020), The increase of standard deviation by 1 in the collateral value of a company would result an increase of 0.26 and 0.55 percentage point in the nondiscretionary and discretionary payment. This effect is stronger on a company with a limited chance for investment. Besides that, a company with higher leverage tends to cut dividends as a response towards the steep decline in its financial flexibility.

De Jong, *et., al.*, (2012) found that a company with a high unused debt capacity would invest in future years rather than a company with low unused debt capacity. A company which tends to be unwilling to get an indefinite period has more probability to issue debts when it has limited access to the capital market.

Hess and Immenkotter (2014) argued that unused debt capacity would indicate a temporary access to external debt and thus measure a company's financial flexibility. A company with a high unused debt capacity would tend to realize most of the opportunities available, get a loan more frequently, and issue a higher volume of debt. A company with a depleted debt capacity would issue the equity or pay its debt if it has a surplus. The pattern in utilizing and recovering unused debt capacity actively indicates that maintaining financial flexibility is the top priority of company's finance.

Bonaimé, *et. al.*, (2016) found that the actual investment buyback negatively impacts the hypothetical investment, which mechanically facilitate the dollar buyback all the time with an average of two percentage points annually. The cost of financial flexibility correlates to the profit management, managerial position and lack of institutional supervision.

Kewangan (2017) mentioned that financial flexibility plays an important role to change the negative correlation between debt funding and financial performance to a more positive correlation. This study functions as a beneficial guideline for MREIT's manager in managing financial flexibility because of having an important moderation effect towards the correlation of financial debts and financial performance.

Harris (2015) argued that a high level of financial flexibility by conducting a stock buyback is positively related to a company's higher level of debt. The biggest positive correlation between companies with above median debt rate in their industry may indicate their lack of additional debt capacity. It is also found that a company may reach a higher financial flexibility by buying back its stock, may be willing to receive less financial flexibility with a higher debt rate.

Teng, *et. al.*, (2021) argued that financial flexibility significantly and positively influences the company performance (return on assets, ROA), especially in a capital intensive manufacturing industries. However, financial flexibility is insignificant towards the performance of light asset manufacturing companies or semiconductor industry.

Lie (2005) mentions that companies with a payment increase may present a surprising positive operational income, especially in the payment of regular dividends. The sudden increase may seem permanent, but any later increase in income would be more limited.

Bukvič (2019) postulated that financial flexibility is the capacity of a company to mobilize its financial resources to cope with an uncertain future. The definition also includes the leverage and cash possession. This is in line with the notion that financial flexibility may be the result of a company's strategic decision on capital structure, liquidity and investment.

Liping *et. al.*, (2013) pointed that a company earning financial flexibility by maintaining low leverage or high cash possession. A company with financial flexibility invests significantly two or three years more after gaining the financial flexibility status, and have better performance compared to its inflexible counterparts.

Riddiough and Steiner, (2020) argued that utilizing debts without collaterals, containing standard agreement limiting the total leverage and the use of debt collateral, correlates to a lower leverage yield. The value of a company is sensitive towards the leverage level, in which a lower leverage correlates to a higher company value. With weaker managerial governance, it is found that a debt without collateral functions as a managerial commitment tool to protect the debt capacity of a company to improve the financial flexibility.

Chen and Hsiao (2014) argued that optimal ownership of insiders and every deviation from it may lead to lower FF. Besides that, FF is higher when CEO ownership is lower (<0.08%) and this phenomenon appears on a company with no financial problem. Besides that, FF is higher when a non-CEO insider's ownership is in the average level (0.12-0.43%) for a financially-limited company. The ownership of a non-CEO insider brings minimum impact to FF for a less financially-limited company.

Gu *et al* (2020) mentioned that short-term managerial of a company with financial flexibility is lower than a company without financial flexibility. This notion applies after all considering all endogenous variables, adjusting the border of financial flexibility definition and the alternate proxy of short-term management. Besides that, the effect of financial flexibility significantly reduces the profit management, which is more significant to private companies and low-risk industries. There is also a higher possibility that a company with financial flexibility would choose one of the Big Four International

Accounting Offices. The company also has lower probability to receive substandard audit opinion or violate the law.

Chen, *et.al.*, (2017) pointed at the sharp increase of debt capacity would result in a smaller cash reserve and a decrease of marginal value of the cash ownership. Lower cash ownership tends to happen more on companies with a higher hedge level, bigger investment opportunity, financial problem, better company governance, and lower volatility on local real estate's price.

Riddiough and Steiner, (2017) emphasized that the value of r_m is sensitive towards the leverage and its stability decreases at first and increases at the end. It is found that an agreement on debt without collateral would function as a managerial commitment tool to maintain the debt capacity of a company and increase its financial flexibility.

Gupta, *et. al.*, (2011) elaborated a regression analysis which clearly showed the fact that financial structure would correlate stronger with a company's financial performance than its financial flexibility. After all, financial flexibility can only be attained during the unexpected impact, while financial structure is related more to the current scenario. Financial flexibility, however, has a 26% more correlation compared to the unknown factor (13%). It can be concluded though that both financial flexibility and structure would impact a company's financial performance.

METHOD

This study is testing the impact of financial flexibility towards company's liquidity with capital structure and risk management as the intervening variable on LQ 45 companies listed in the Indonesian Stock Exchange in order to know the company's ability to fulfill its short-term liabilities.

Financial flexibility (X_1) as a dependent variable, is the level of capacity and quickness of a company to mobilize its financial resources or take preventive, reactive and exploitative actions to optimize the company's valuation (Byoun, 2008)

1. Capital Structure (Z_{12}) as an independent variable is a balancing or comparison between the owner's capital and foreign capital. In this case, the owner's capital will be held and become company's possession, while foreign capital would be in the form of short-term or long-term debts.
2. Company's liquidity (Z) is a company's ability in fulfilling its short-term liability when it is due. Another definition is the ability of a person or company to fulfill his or its liabilities or debts.

Data collected for this study are secondary data, originated from the annual report of LQ 45 companies enlisted in the Indonesian Stock Exchange in the year of 2020 and 2021 during the period of Covid-19 pandemic. These annual reports would be used due to their nature of including operational and financial activities of the companies.

For testing the hypothesis: the impact of financial flexibility towards the company's liquidity with capital structure and risk management as the intervening variables, this study utilized the Moderated Regression Analysis (MRA) statistical tool. MRA is used specifically for double linear regression in which the regression formula contains an interaction variable (a multiplication of two or more independent variables) in order to find the correlation between the variables.



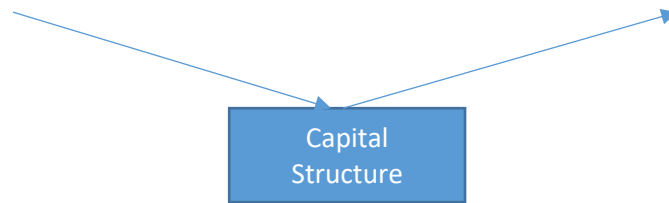


Figure 1 Conceptual Framework

RESULTS AND DISCUSSION

To know the direct and indirect impacts of financial flexibility towards the company's liquidity with a capital structure as the moderator, the following tests using SmartPLS have been conducted. The calculation results are as the following:

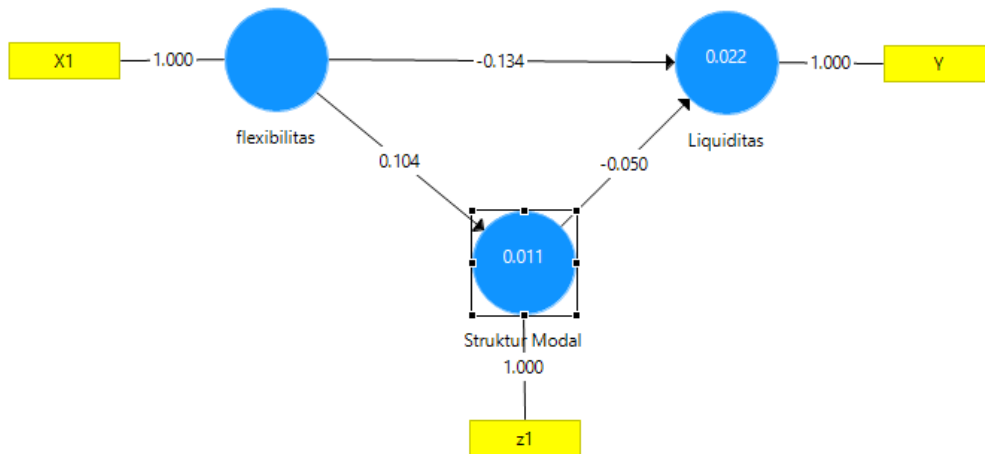


Figure 1 Conceptual Framework Analysis

From the calculation model above using Smart PLS, the flexibility variable has a positive influence towards the company's capital structure by 0.104 and become insignificant with a Sig value of 0.327 or above 0.05. The flexibility variable impacts liquidity negatively by -0.134 or above 0.05. As for the capital structure variable, it affects the liquidity negatively by 0.050 and become insignificant with a Sig value of 0.327.

Results of this study failed to confirm the results of Liping *et. al*, (2013), and Riddiough and Steiner E (2020). The company has financial flexibility by maintaining a low level of leverage or a high level of cash at hand. A company with financial flexibility would invest two or three years more after gaining the flexibility status and has a better performance from its inflexible counterparts. The utilization of debt without collateral, containing standard agreement to limit the total leverage and debt collateral utilization, is connected to a lower leverage yield. This showed that a company value is sensitive to the level of leverage, in which lower leverage level is correlated to a higher value of the company. With weak managerial governance, an agreement of a debt without collateral would function as the managerial commitment tool to protect the debt capacity of the company to increase the financial flexibility.

CONCLUSION (Capital, 12 pts, bold)

From the discussion, it can be concluded that flexibility deliver a positive and insignificant impact towards the company's liquidity. Results showed that the financial flexibility significantly influences the company's liquidity while it insignificantly affects the capital structure. Future study should conduct a reserch on financial flexibility towards the company's liquidity by adding other variables from the ones used in this study.

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