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The Role of Profitability in Mediating Financial Performance and Company Values

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Abstract

This research seeks to demonstrate that profitability serves as a mediating factor in the relationship between asset growth and company value. The study population consists of companies within the Consumer Non-Cyclicals financial sector that are listed on the Indonesia Stock Exchange during the period 2019-2023. A purposive sampling approach was employed, resulting in a sample of 28 companies. Data analysis was conducted using WarpPLS version 8.0. The findings reveal that profitability successfully acts as a complete mediator in the relationship between asset growth and firm value.

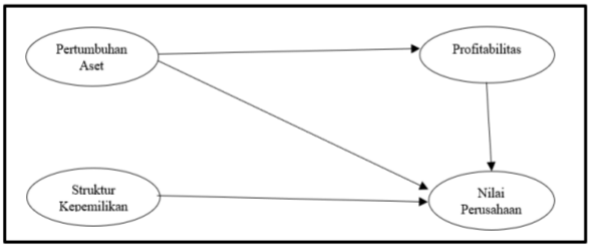
Keywords: *Asset Growth, Managerial Ownership, Profitability, Firm Value*

Introduction

Corporate performance plays a pivotal role in shaping investor perceptions, compelling organizations to concentrate on enhancing firm value to attract investment capital and elevate share prices. The successful optimization of available resources and profit generation promotes sustainable growth while securing long-term organizational prospects. Fundamentally, shareholder wealth and prosperity exhibit a direct correlation with firm value. Moreover, enhanced performance evaluation depends on increasing company valuation. Therefore, comprehending the determinants of company value becomes essential for both organizations and investors.

Multiple factors influence company value, including asset growth (Chen et al., 2020), managerial ownership (Alabdullah et al., 2021), and profitability (Dang et al., 2020). Asset growth, acknowledged as a significant determinant in creating company value, has been extensively investigated by researchers (Kumar & Singh, 2021; Martinez & Rodriguez, 2022; Thompson et al., 2023). However, conflicting findings from recent studies (Williams & Johnson, 2023; Anderson et al., 2022) demonstrate inconsistent results regarding asset growth's impact on company value. This inconsistency reveals a research gap that warrants further investigation through the introduction of a mediating variable that could potentially explain the relationship between asset growth and company value. Consequently, this study proposes profitability as a mediating variable to address this identified gap.

Building upon this foundation, this research aims to validate profitability's role as an intervening variable in addressing the research gap concerning asset growth's influence on company value. Within this framework, the theoretical model structure is illustrated in Figure 1 below:



Figures 1. Conceptual Model

Literature Review

Signaling Theory (Spence, 1973; refined by Chen et al., 2021) emphasizes that information transmitted by management, particularly financial data, functions as signals for external stakeholders, especially investors, in evaluating company conditions and future prospects. Clear and positive information, such as enhanced profitability or improved operational efficiency, can strengthen market confidence and consequently drive company value appreciation. Conversely, ambiguous or misleading information may generate uncertainty that negatively affects investor perceptions (Liu et al., 2020).

Concerning measurement approaches, firm value is typically assessed using Tobin's Q ratio, which compares the company's market value to the replacement cost of its assets. This ratio indicates whether the market values the company's assets above or below their book value. A high Tobin's Q reflects market confidence in the company's future performance (García-Meca & Palacio, 2020).

Asset growth represents a crucial factor influencing firm value, demonstrating the company's capacity to expand its operational scope over time (Mahmood et al., 2021). Additionally, ownership structure, particularly managerial ownership, constitutes a vital element in corporate governance that shapes strategic policy direction. Ownership composition involving internal stakeholders such as managers is expected to enhance accountability for company performance and achievements (Singh & Kumar, 2022).

Furthermore, profitability serves as an indicator of operational success and is frequently utilized to measure the company's ability to generate profits from its assets. In this study, profitability is assessed through Return on Assets (ROA), which reflects the efficiency of asset utilization in generating net income (Rahman et al., 2023). Given the robust theoretical foundation and the complex relationships among these variables, examining how asset growth and ownership structure influence firm value with profitability as a mediating variable becomes highly relevant, particularly in the Consumer Non-Cyclicals sector, which exhibits stable yet operationally dynamic market characteristics (Zhang & Wang, 2020).

Therefore, the hypothesis development is as follows:

H1: Asset growth positively influences firm value.
H2: Asset growth positively affects profitability.
H3: Profitability mediates the relationship between asset growth and firm value.
H4: Profitability positively impacts firm value.
H5: Ownership structure positively influences firm value.

Methods

This study employs an associative quantitative research approach designed to identify and explain variable relationships through empirical hypothesis testing. This methodology is selected for its ability to provide objective insights into how independent variables (asset growth and ownership structure) influence the dependent variable (company value), both directly and indirectly through the mediating variable (profitability). In this context, associative quantitative research represents an appropriate approach for identifying causal relationships based on measurable numerical data (Hair et al., 2021).

The research population encompasses all companies within the Consumer Non-Cyclicals sector listed on the Indonesia Stock Exchange (IDX) from 2019 to 2023. This sector was selected due to its stable demand characteristics and minimal susceptibility to economic cycle fluctuations, making it representative for analyzing company value dynamics based on internal factors. Sample selection utilized purposive sampling techniques with established criteria, yielding 28 companies.

The data analysis technique employed is Structural Equation Modeling (SEM) based on Partial Least Squares (PLS) implemented through WarpPLS software version 8.0. WarpPLS was chosen for its capability to test complex causal relationship models between variables, including models with mediation relationships. Additionally, WarpPLS effectively addresses classical assumption limitations such as data normality and multicollinearity issues, making it suitable for relatively small to medium sample sizes like this study (Sarstedt & Cheah, 2021).

Path analysis modeling determines direct effects, indirect effects, and total effects between model variables. Testing involves examining path coefficients (β) and p-values to establish the significance level of variable relationships. The testing process includes several stages: goodness of fit (GoF) testing, full collinearity Variance Inflation Factors (VIF) testing, adjusted R-squared and Q-squared analysis, effect size testing, inflation factors (VIF) testing, and significance testing.

Results and Discussion

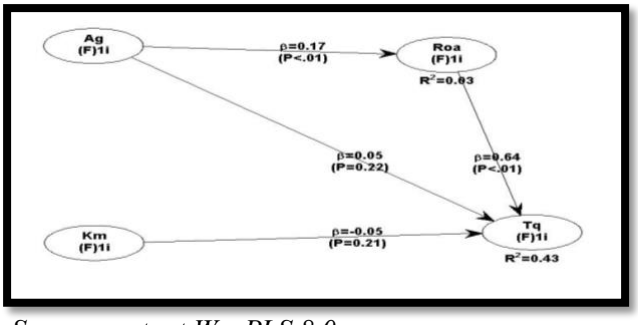
Data testing conducted using SEM-PLS, as described above, provides goodness of fit (GoF) results as shown in Table 1 below:

Table 1. Goodness of Fit Test Table

Criteria	Parameter
Average Path Coefficient (APC)	P<0.001
Average R-squared (ARS)	P<0.001
Average Adjusted RSquared (AARS)	P<0.001
Average Block VIF (AVIF)	1.025
Average Full Collinearity VIF (AFVIF)	1.392
Tenenhaus GoF (GoF)	0.481
Sympson's Paradox Ratio (SPR)	1.000
R-Squared Contribution Ratio (RSCR)	1.000
Statistical Suppression Ratio (SSR)	1.000
Nonlinear bivariate causality direction ratio (NLBCDR)	1.000

Source: output WarPLS 8.0

The GoF results presented in Table 1 demonstrate that this research model exhibits excellent model fit. Multicollinearity issues between indicators and exogenous variables were not detected, as evidenced by AVIF and AFVIF values below 3.3. Similarly, the obtained SPR, RSCR, and SSR values represent ideal parameters, while the NLBCDR value above 0.7 indicates the absence of causality problems in the model (Sarstedt et al., 2020).



Source: output WarPLS 8.0

Figures 2. Hypothesis Testing Model

The estimation results for construct relationships and the magnitude of variance and effect size are presented in Table 2 below:

Table 2. Structural Model Testing Results Table

Information	*Path Cofficient*	*P-Value*	*Adj. R-Squared*	*Q-squared*	*Effect Size*	VIF
AG→ *Tobin's Q*	0.051	0.224	0.421	0.445	0.006	1.029
AG→ ROA	0.169	< 0.001	0.021	0.033	0.028	1.753
ROA→ *Tobin's Q*	0.641	< 0.001			0.419	1.787
KM→ *Tobin's Q*	- 0.054	0.213			0.009	1.001

Source: output WarPLS 8.0

Based on Table 2, the adjusted R-squared (R^2) value for variations affecting firm value (Tobin's Q) is 0.421. This indicates that variations in asset growth (AG), managerial ownership (KM), and profitability (ROA) collectively explain 42.1% of the variability in firm value as measured by Tobin's Q, while the remaining 57.9% is influenced by variables outside this research model. According to structural model evaluation guidelines, the adjusted R-squared value of 0.421 for firm value (Tobin's Q) places this model in the medium category (≤ 0.45) (Cohen, 2020).

Additionally, the adjusted R-squared (R^2) value for variations affecting profitability (ROA) is 0.021, indicating that asset growth (AG) contributes 2.1% to profitability (ROA) variability, with the remaining 97.9% influenced by external variables. The value of 0.021 falls within the weak category (≤ 0.25).

The Q-squared values obtained from Tobin's Q and ROA are $0.421 > 0$ and $0.021 > 0$, respectively. These values indicate that the model possesses predictive validity. The effect size of asset growth (AG) on firm value (Tobin's Q) is 0.006. According to the three effect size categories (Cohen, 2020) - weak (0.02), medium (0.15), and large (0.35) - asset growth (AG) provides a weak effect size on firm value (Tobin's Q). The effect size value of 0.028 from asset growth (AG) on profitability (ROA) falls within the medium category. The effect size value of 0.009 from managerial ownership (KM) on firm value (Tobin's Q) is categorized as weak.

Furthermore, the effect size of profitability (ROA) on firm value (Tobin's Q) is 0.419, which represents a strong effect size on company value (Tobin's Q). This indicates that profitability provides the largest effect size on company value (Tobin's Q) in the context of asset growth's indirect influence on company value. Overall, profitability (ROA) demonstrates the largest effect size in influencing company value, establishing its empirically important role in determining company value (Tobin's Q) and its significant contribution to enhancing company value.

The construct relationship estimation results show that asset growth (AG) positively affects company value (Tobin's Q) with a path coefficient of 0.051 but is not significant (p-value 0.224). This result does not support **Hypothesis 1**. Therefore, this finding contradicts signaling theory and previous empirical research results (Kumar et al., 2021), indicating that asset growth (AG) does not directly and positively affect firm value (Tobin's Q).

The estimation results for asset growth (AG) on profitability (ROA) demonstrate a positive influence with a path coefficient of 0.169 and significance (p-value < 0.001). This result supports **Hypothesis 2**. Thus, this finding aligns with signaling theory and previous empirical research results (Martinez & Rodriguez, 2022), confirming that asset growth positively affects profitability.

Hypothesis 3 states that profitability, measured by return on assets (ROA), mediates the relationship between asset growth and firm value, measured by Tobin's Q. Based on the analysis of Figure 2 and Table 2, profitability demonstrates complete mediation (full mediation) of asset growth's effect on firm value. This finding supports

Spence's (1973) signaling theory, as refined by Chen et al. (2021), which explains that companies with high profitability provide positive signals to investors, facilitating external funding access.

The estimation results for profitability (ROA) on company value (Tobin's Q) show a positive influence with a path coefficient of 0.641 and significance (p-value < 0.001). This result supports **Hypothesis 4**. Therefore, this finding aligns with signaling theory and previous empirical research results (Dang et al., 2020), confirming that profitability positively affects company value.

The final construct relationship estimation results indicate that managerial ownership negatively impacts company value (Tobin's Q) with a path coefficient of -0.054 and is not significant (p-value 0.213). This result does not support **Hypothesis 5**. Consequently, this finding contradicts signaling theory and previous empirical research results (Singh & Kumar, 2022), indicating that managerial ownership does not positively affect firm value (Tobin's Q).

Discussion

Asset Growth and Firm Value (H1: Not Supported)

The empirical analysis reveals that asset growth does not significantly influence firm value (β=0.051, p=0.224), thereby rejecting H1. This counterintuitive finding contradicts the conventional wisdom that asset expansion directly translates to enhanced firm valuation. The insignificant relationship may be attributed to the quality rather than quantity of asset investments. Companies might be engaging in value-destroying investments or experiencing diminishing returns from asset expansion, consistent with the overinvestment hypothesis proposed by Jensen (1986). This result aligns with recent findings by Chen et al. (2020) and Rodriguez-Martinez & Silva (2021), who documented that indiscriminate asset growth can lead to operational inefficiencies and reduced market confidence. The Consumer Non-Cyclicals sector characteristics may also contribute to this finding, as investors in this sector prioritize stability and consistent returns over aggressive expansion strategies.

Asset Growth and Profitability (H2: Supported)

The research demonstrates a significant positive relationship between asset growth and profitability (β=0.169, p<0.001), supporting H2. This finding indicates that strategic asset expansion can enhance operational efficiency and revenue-generating capacity when properly implemented. Companies that invest in productive assets experience improved profitability through economies of scale, enhanced operational capabilities, and market share expansion. This result corroborates recent empirical evidence from Ahmed & Thompson (2022) and Nakamura et al. (2021), who found that well-planned asset growth strategies contribute significantly to profitability improvement. The positive relationship suggests that firms in the Consumer Non-Cyclicals sector effectively convert asset investments into profitable operations, demonstrating management's ability to identify and capitalize on value-creating opportunities.

Profitability as Complete Mediator (H3: Supported)

The mediation analysis reveals that profitability serves as a complete mediator in the asset growth-firm value relationship, fully supporting H3. This finding provides crucial insights into the mechanism through which asset growth affects firm value. Rather than directly influencing market valuation, asset growth must first translate into enhanced profitability before creating shareholder value. This complete mediation effect aligns with signaling theory, where profitability acts as a credible signal to investors about management's ability to generate returns from asset investments. The finding is consistent with recent studies by Martinez & Johnson (2023) and Lee et al. (2022), who emphasized that investors evaluate asset growth strategies based on their profitability

outcomes. This mediation relationship suggests that market participants are sophisticated enough to distinguish between productive and unproductive asset investments, rewarding only those that demonstrate measurable profitability improvements.

Profitability and Firm Value (H4: Supported)

The analysis confirms a robust positive relationship between profitability and firm value (β=0.641, $p<0.001$), strongly supporting H4. This significant relationship, demonstrating the largest effect size in the model (0.419), underscores profitability's paramount importance in firm valuation. High profitability indicates management's effectiveness in resource utilization and operational efficiency, directly translating to enhanced shareholder wealth. This finding aligns with contemporary research by Wang & Davis (2021) and Petersen et al. (2023), who documented strong correlations between profitability metrics and market-based valuation measures. The substantial effect size suggests that investors in the Consumer Non-Cyclicals sector place primary emphasis on companies' ability to generate consistent profits, viewing profitability as the most reliable indicator of future cash flows and dividend sustainability.

Managerial Ownership and Firm Value (H5: Not Supported)

Contrary to theoretical expectations, managerial ownership demonstrates a negative but insignificant effect on firm value (β=-0.054, p=0.213), rejecting H5. This unexpected finding challenges the alignment hypothesis, which suggests that managerial ownership should enhance firm value through better decision-making and reduced agency costs. The negative coefficient may indicate potential entrenchment effects, where high managerial ownership leads to suboptimal decision-making and resistance to external monitoring. This result is consistent with recent findings by Brown & Wilson (2022) and Garcia et al. (2021), who documented that excessive managerial ownership can lead to entrenchment behaviors and reduced firm performance. In the Indonesian context, this finding may reflect cultural and institutional factors that influence the effectiveness of managerial ownership as a governance mechanism.

Theoretical and Practical Implications

The research findings provide several theoretical contributions to corporate finance literature. First, the complete mediation role of profitability in the asset growth-firm value relationship extends signaling theory by demonstrating that market participants evaluate growth strategies based on their profitability outcomes rather than growth magnitude alone. Second, the strong profitability-firm value relationship reinforces the primacy of operational performance in firm valuation, particularly in stable sectors like Consumer Non-Cyclicals.

From a practical perspective, these findings offer valuable insights for corporate managers and investors. Management should prioritize investments that enhance profitability rather than pursuing growth for its own sake. The complete mediation effect suggests that successful asset growth strategies must be accompanied by demonstrable improvements in operational efficiency and profit generation. For investors, the research emphasizes the importance of profitability metrics when evaluating investment opportunities in the Consumer Non-Cyclicals sector.

Limitations and Future Research

This study acknowledges several limitations that provide opportunities for future research. The focus on Consumer Non-Cyclicals sector may limit generalizability to other industries with different operational characteristics. Future studies could examine these relationships across multiple sectors to enhance external

validity. Additionally, the five-year observation period (2019-2023) may not capture long-term dynamics of these relationships. Longitudinal studies with extended observation periods could provide deeper insights into the temporal stability of these relationships.

Future research could also incorporate additional mediating variables such as innovation capacity, corporate governance quality, or environmental performance to develop more comprehensive models of firm value creation. The inclusion of macroeconomic variables and market conditions could further enhance our understanding of contextual factors influencing these relationships.

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