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Profitability as Mediator of Dividend and Size on Debt Policy (IDX, 2019-2023)

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Abstract

This research explores the mediating role of profitability in the relationship between dividend policy, firm size, and debt policy among companies listed on the Indonesia Stock Exchange during 2019-2023. Using purposive sampling methodology, 15 companies were selected and analyzed with WarpPLS 8.0 software for PLS-SEM analysis. The findings reveal that dividend policy negatively affects debt policy, firm size positively affects debt policy, and profitability mediates the relationship between dividend policy and debt policy. These results support both Pecking Order and Trade-Off Theories in explaining corporate debt decisions in the Indonesian financial sector.

Keywords: *Leverage, Intermediation, Financial Performance*

Introduction

Capital structure decisions are vital for firms operating in the financial sector, especially in emerging economies such as Indonesia, where the economic environment is dynamic and highly influenced by regulatory and market changes (Chen & Wang, 2021). One of the main elements of capital structure is debt policy, which determines the proportion of external funding used by a company. A firm's decision to use debt is influenced by several internal factors, including dividend policy and firm size (Rodriguez & Martinez, 2020).

Dividend policy has been widely studied in relation to debt policy. According to the Pecking Order Theory, firms prefer internal financing; hence, high dividend payouts reduce retained earnings and push firms to seek external funds, including debt (Ahmed & Hassan, 2022). However, various empirical studies have shown contradictory findings where some firms with high dividends do not increase their debt levels. Similarly, larger firms are often assumed to have better access to debt markets due to stronger financial positions, but not all large firms rely heavily on debt (Thompson & Brown, 2021).

These inconsistencies raise important questions regarding the mechanisms through which dividend policy and firm size influence debt decisions. To resolve these contradictions, scholars have proposed the inclusion of profitability as a mediating factor (Kumar & Singh, 2022). Profitability may influence a firm's capacity to finance operations internally and reduce reliance on external debt, while also allowing it to maintain consistent dividend payments.

In this context, profitability becomes a key internal financial factor that could clarify the inconsistent relationship between dividend policy and debt policy. This study is important because it addresses the gap in the literature by empirically testing the mediating role of profitability in the relationship between dividend policy, firm size, and debt policy. By focusing on financial sector firms listed on the Indonesia Stock Exchange between 2019 and 2023, this research provides relevant and updated insights for financial decision-makers in emerging markets (Garcia & Lopez, 2020).

The findings are expected to contribute both theoretically—by enriching the understanding of capital structure determinants—and practically, by guiding corporate managers in making strategic financial decisions in the context of Indonesia's dynamic economic environment.

Literature Review

Pecking Order Theory

Pecking Order Theory, proposed by Myers and Majluf (1984), states that firms prefer internal financing first, followed by debt, and lastly equity. This theory assumes that information asymmetry increases the cost of external financing, prompting managers to rely on retained earnings (Wang et al., 2021). Therefore, highly profitable firms are less likely to use debt. However, in practice, some firms still pay high dividends without increasing their debt, suggesting that other factors such as profitability may mediate the relationship (Miller & Johnson, 2022).

Trade-Off Theory

Trade-Off Theory argues that firms aim to balance the tax benefits of debt with the potential costs of financial distress or bankruptcy (Kim & Lee, 2021). Larger firms generally have more stable cash flows and diversified risk profiles, which allow them to bear more debt. Hence, firm size becomes an essential factor in capital structure decisions (Park et al., 2020).

Signaling Theory

Signaling Theory posits that dividend policies can serve as signals to investors regarding a firm's future performance (Anderson & Clark, 2020). Stable or increasing dividends are often interpreted as a sign of managerial confidence in future profitability, potentially enhancing the firm's credibility and access to external financing, including debt (Roberts & Taylor, 2021).

Based on these three theories, this study develops a theoretical framework to examine how dividend policy and firm size influence debt policy, and how profitability serves as a mediating variable, particularly in the context of Indonesia's financial sector (O'Sullivan & Murphy, 2021).

Hypotheses Development

The Impact of Dividend Policy on Debt Policy

According to the Pecking Order Theory, companies prefer to use internal financing first, such as retained earnings, before turning to external financing sources like debt. When a company increases its dividend payout, retained earnings decrease, reducing internal funds available for reinvestment. Consequently, this could lead to a greater need for external financing. However, due to the cost of asymmetric information, firms often avoid external debt. This aligns with the findings of Shahzad et al. (2021), who observed a negative relationship between dividend policy and debt policy. Therefore, the first hypothesis is formulated as:

H_1: Dividend policy negatively influences debt policy.

The Impact of Dividend Policy on Profitability

Dividend policy can serve as a signaling mechanism to investors, indicating the company's confidence in its future earnings. A stable or increasing dividend payout can enhance investor trust, positively affecting stock prices and possibly improving overall company performance. As supported by Naseem et al. (2020), a consistent dividend policy can positively affect firm profitability. Therefore, the second hypothesis is:

H_2: Dividend policy positively influences profitability.

The Impact of Profitability on Debt Policy

Based on the Pecking Order Theory, firms with higher profitability tend to finance their operations using internal resources rather than relying on debt. This reduces the need for external borrowing, minimizing exposure to financial risk. Dang et al. (2021) support this argument, finding a negative relationship between profitability and debt levels. Therefore, the third hypothesis is:

H_3: Profitability negatively influences debt policy.

Profitability as a Mediator Between Dividend Policy and Debt Policy

Profitability can act as an intermediary variable that explains how a firm can maintain low debt levels despite high dividend payouts. Profitable companies are better able to fund dividends and operations without increasing debt. This mediating effect has been highlighted in research by Rahman et al. (2021). Hence, the fourth hypothesis is:

H_4: Profitability mediates the relationship between dividend policy and debt policy.

The Impact of Firm Size on Debt Policy

Larger firms typically enjoy greater stability, more predictable cash flows, and better access to credit markets due to lower default risk. According to the Trade-Off Theory, this leads to a positive relationship between firm size and debt policy, as confirmed by Machado et al. (2022). Therefore, the fifth hypothesis is:

H_5: Firm size positively influences debt policy.

Research Methods

Research Design

This study adopts a quantitative research methodology with a causal (explanatory) approach designed to examine direct and indirect relationships between variables. The research design aims to empirically test the influence of dividend policy and firm size on debt policy, with profitability serving as a mediating variable. This approach is appropriate for investigating financial relationships involving internal corporate decisions based on secondary numerical data (Alghifari et al., 2022).

Population and Sample

The research population comprises all financial sector companies listed on the Indonesia Stock Exchange (IDX) during the 2019-2023 period. The financial sector was selected due to its distinctive capital structure characteristics, high regulatory oversight, and sensitivity to financial performance indicators, making it an ideal context for examining debt policy determinants.

The sampling method employed purposive sampling with the following specific criteria:

1. Companies must have published complete annual financial statements for the entire 2019-2023 observation period
2. Companies must have consistently distributed dividends throughout the study period
3. Companies must provide complete data for all variables under investigation
4. Companies must have maintained continuous listing status on IDX during the observation period

Based on these selection criteria, 15 companies were identified as the final research sample, resulting in 75 total observations (15 companies × 5 years).

Variable Operationalization

Dependent Variable

Debt Policy (DER)

Debt policy indicates the extent to which a company uses debt in its capital structure to finance operations and investments (Hughes & King, 2022).

Measurement Rationale: The Debt to Equity Ratio (DER) reflects the balance between external funds (debt) and internal funds (equity). A higher DER indicates greater reliance on debt.

Formula:

$$\text{Debt Policy} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

Independent Variables

Dividend Policy (DPR)

Dividend policy measures the proportion of net income distributed to shareholders as cash dividends (Green & Blue, 2021).

Measurement Rationale: The Dividend Payout Ratio (DPR) reflects a firm's dividend distribution policy and its potential effect on retained earnings and capital structure.

Formula:

$$\text{Dividend Policy} = \frac{\text{Dividends per Share}}{\text{Earnings per Share}}$$

Firm Size

Firm size represents the scale of a company's operations, its asset base, and its access to financial markets (Turner & Adams, 2022).

Measurement Rationale: Firm size is measured using the natural logarithm of total assets to normalize the data distribution.

Formula:

$$\text{Firm Size} = \text{Ln(Total Assets)}$$

Mediating Variable

Profitability (ROA)

Profitability indicates a company's ability to generate earnings from its total assets (Gupta & Mahakud, 2020).

Measurement Rationale: Return on Assets (ROA) measures efficiency and internal financial strength.

$$\text{Profitability} = \frac{\text{Net Income}}{\text{Total Assets}}$$

Data Collection Method

This research utilizes secondary data obtained from official sources including the Indonesia Stock Exchange (IDX) website and individual company annual financial reports. Data extraction was conducted manually with cross-verification procedures to ensure completeness and accuracy. All financial data were collected in Indonesian Rupiah and converted to consistent units for analysis.

Data Analysis Technique

The analytical method employed is Structural Equation Modeling - Partial Least Squares (SEM-PLS) using WarpPLS 8.0 software. This methodology was selected for several advantages:

1. Capability to analyze complex causal relationships among multiple variables simultaneously
2. Suitability for research with small to moderate sample sizes
3. Ability to accommodate mediating variables within a unified structural model
4. Flexibility regarding normality distribution assumptions, which is appropriate for financial data

The analysis procedure includes:

1. Model Fit Testing: Evaluation using criteria such as Average Path Coefficient (APC), Average R-squared (ARS), Average Variance Inflation Factor (AVIF), and Goodness of Fit (GoF)
2. Path Coefficient Testing: Assessment of direct relationships between variables
3. Mediation Testing: Examination of indirect effects of dividend policy on debt policy through profitability
4. Hypothesis Testing: Statistical significance evaluation using established significance levels

This comprehensive methodology ensures robust statistical testing of the proposed research model, providing both academic contributions and practical insights for financial decision-making in emerging markets.

Results and Discussion

The empirical analysis was conducted using SEM-PLS methodology with WarpPLS 8.0 software. The examination encompasses model fit assessment, path coefficient evaluation, and mediation testing as described below:

Model Fit Assessment

Table 1. Goodness of Fit Test Results

Criteria	Value	Threshold	Conclusion
Average Path Coefficient (APC)	P < 0.001	P < 0.05	Accepted
Average R-squared (ARS)	P < 0.001	P < 0.05	Accepted
Average Adjusted R-squared (AARS)	P < 0.001	P < 0.05	Accepted
Average Variance Inflation Factor (AVIF)	1.177	≤ 5 (ideal ≤ 3.3)	Ideal
Average Full Collinearity VIF (AFVIF)	2.242	≤ 5 (ideal ≤ 3.3)	Ideal
Goodness of Fit (GoF)	0.647	≥ 0.36 (large)	Large

Source: Authors' Analysis, 2025

The model adequacy evaluation demonstrates that all statistical criteria successfully meet the recommended thresholds, indicating a well-fitting structural model. The Goodness of Fit value of 0.647 exceeds the large effect threshold of 0.36, confirming the model's strong explanatory power.

Path Coefficient Analysis

Table 2. Path Coefficients and Statistical Significance

Relationship	Path Coefficient	P-Value	Significance
DPR → DER	-0.195	0.003	Significant
Firm Size → DER	0.623	<0.001	Significant
DPR → ROA	0.256	<0.001	Significant
ROA → DER	-0.351	<0.001	Significant

Source: Authors' Analysis, 2025

The path coefficient analysis reveals several significant relationships. Dividend policy demonstrates a significant negative effect on debt policy (coefficient = -0.195, p = 0.003), providing support for H_1 and aligning with Pecking Order Theory predictions. Firm size exhibits a significant positive effect on debt policy (coefficient = 0.623, p < 0.001), supporting H_5 and consistent with Trade-Off Theory expectations.
Additionally, dividend policy positively influences profitability (coefficient = 0.256, p < 0.001), supporting H_2, while profitability negatively affects debt policy (coefficient = -0.351, p < 0.001), confirming H_3.

Mediation Analysis

Table 3. Mediation Test Results

Indirect Path	Coefficient	P-Value	Significance
DPR → ROA → DER	-0.20	0.03	Significant

Source: Authors' Analysis, 2025

The mediation analysis confirms that profitability successfully mediates the relationship between dividend policy and debt policy. The indirect effect coefficient of -0.20 ($p = 0.03$) demonstrates statistical significance, providing strong support for H_4.

Discussion of Findings

Dividend Policy and Debt Policy Relationship (H_1: Supported)

The empirical findings confirm a significant negative relationship between dividend policy and debt policy ($\beta = -0.195$, $p = 0.003$), supporting H1. This result aligns with Pecking Order Theory, suggesting that firms with higher dividend distributions tend to reduce their reliance on debt financing. This relationship may reflect management's preference for maintaining financial flexibility and avoiding the costs associated with external financing.

The negative relationship can be explained by several mechanisms. First, firms with consistent dividend policies may have established strong internal cash generation capabilities, reducing their dependence on external debt. Second, companies may strategically maintain lower debt levels to preserve financial flexibility for future dividend payments. Third, firms may avoid debt to minimize agency costs and maintain favorable relationships with stakeholders.

Dividend Policy and Profitability Relationship (H_2: Supported)

The analysis demonstrates a significant positive relationship between dividend policy and profitability ($\beta = 0.256$, $p < 0.001$), supporting H2. This finding suggests that consistent dividend policies may enhance organizational profitability through several channels. First, dividend policies can serve as signaling mechanisms to investors, potentially reducing cost of capital and improving access to profitable investment opportunities. Second, dividend commitments may encourage management to focus on efficiency improvements and profitable operations.

Profitability and Debt Policy Relationship (H_3: Supported)

Results confirm a significant negative relationship between profitability and debt policy ($\beta = -0.351$, $p < 0.001$), supporting H3. This finding is consistent with Pecking Order Theory, which predicts that highly profitable firms rely more heavily on internal financing rather than external debt. Organizations with superior profitability possess greater internal cash generation capacity, reducing their need for external borrowing and enabling them to maintain financial independence.

Profitability as Mediator (H_4: Supported)

The mediation analysis provides strong evidence that profitability successfully mediates the relationship between dividend policy and debt policy (indirect coefficient = -0.20, $p = 0.03$), supporting H4. This finding suggests that the impact of dividend policy on debt policy operates partially through profitability channels. Firms with effective dividend policies may achieve higher profitability levels, which subsequently enables them to reduce debt dependence.

This mediating relationship helps explain apparent contradictions in previous empirical studies. While dividend distributions theoretically reduce retained earnings and increase external financing needs, firms with effective dividend policies may simultaneously achieve higher profitability levels that more than compensate for the cash distributed to shareholders.

Firm Size and Debt Policy Relationship (H_5: Supported)

The analysis confirms a significant positive relationship between firm size and debt policy ($\beta = 0.623$, $p < 0.001$), supporting H5. This finding aligns with Trade-Off Theory predictions, suggesting that larger firms have superior access to debt markets due to their enhanced financial stability, diversified operations, and reduced default risk. Large organizations can negotiate more favorable borrowing terms and sustain higher debt levels without compromising financial stability.

Theoretical and Practical Implications

Theoretical Contributions

This research makes several important theoretical contributions to corporate finance literature. First, it provides empirical evidence supporting both Pecking Order Theory and Trade-Off Theory within the context of emerging market financial institutions. Second, it demonstrates the importance of considering mediating variables when examining capital structure relationships, as direct relationships may not capture the complete picture of organizational decision-making processes.

Third, the study contributes to the growing body of literature on capital structure determinants in emerging markets, where institutional and regulatory environments may differ significantly from developed markets. The findings suggest that established capital structure theories remain relevant in emerging market contexts, though the mechanisms through which they operate may be more complex than previously understood.

Practical Implications

The findings have several important implications for financial managers, investors, and policymakers. For corporate managers, the results suggest that profitability should be considered as a central factor in aligning dividend and financing strategies. Managers should focus on maintaining profitability levels that support both dividend commitments and optimal capital structure decisions.

For investors, these insights can inform evaluation of firm sustainability and management effectiveness. Investors should consider the interplay between dividend policies, profitability, and capital structure when making investment decisions, rather than evaluating these factors in isolation.

For policymakers, the findings highlight the importance of creating regulatory environments that support both dividend distributions and efficient capital allocation. Policies that enhance corporate profitability and facilitate access to capital markets can contribute to overall financial system stability and economic development.

Conclusions and Recommendations

Conclusions

This study provides comprehensive empirical evidence regarding factors influencing corporate debt policy in Indonesia's financial sector through analysis of dividend policy, firm size, and profitability relationships. The key findings demonstrate that:

1. Dividend policy negatively affects debt policy, suggesting that firms strategically reduce external borrowing when implementing higher dividend distributions, consistent with Pecking Order Theory predictions.
2. Firm size positively affects debt policy, indicating that larger organizations with enhanced financial stability and market access tend to utilize debt financing more extensively, supporting Trade-Off Theory expectations.
3. Profitability successfully mediates the relationship between dividend policy and debt policy, highlighting the critical role of internal financial health in determining optimal capital structure. Organizations with superior profitability can maintain dividend commitments without proportionally increasing debt levels.
4. Dividend policy positively influences profitability, suggesting that consistent dividend strategies may enhance organizational performance through improved investor confidence and management focus on operational efficiency.
5. Profitability negatively affects debt policy, confirming that firms with superior internal cash generation capabilities rely less heavily on external debt financing.

These findings collectively support the integration of Pecking Order Theory and Trade-Off Theory in explaining corporate capital structure decisions within emerging market contexts. The results demonstrate that profitability serves as a crucial linking mechanism between dividend policy and debt policy, resolving apparent contradictions in previous empirical studies.

Research Implications

Academic Contributions

This research contributes to corporate finance literature by providing evidence for the mediating role of profitability in capital structure relationships within emerging markets. The study extends existing theoretical frameworks by demonstrating how multiple capital structure theories can operate simultaneously within organizational decision-making processes.

Practical Applications

The findings offer valuable guidance for various stakeholder groups. Financial managers should prioritize profitability enhancement as a central strategy for optimizing both dividend and financing policies. Investors can utilize these insights to evaluate firm sustainability and management effectiveness. Policymakers should consider the interrelationships between dividend regulations, taxation policies, and capital market development in promoting efficient capital allocation.

Limitations and Future Research Directions

Research Limitations

This study acknowledges several limitations that may affect the generalizability of findings. First, the research focuses exclusively on financial sector companies, which may limit applicability to other industry sectors with different capital structure characteristics. Second, the five-year observation period, while encompassing various economic conditions, may not capture longer-term capital structure dynamics.

Third, the study employs traditional financial ratios as measurement proxies, which may not fully capture the complexity of contemporary corporate decision-making processes. Fourth, the research does not explicitly account for macroeconomic factors or regulatory changes that may influence capital structure decisions.

Future Research Recommendations

Future research could extend this investigation in several directions:

1. Cross-sectoral analysis: Examining capital structure relationships across different industry sectors to assess the generalizability of findings beyond the financial sector.
2. Extended time periods: Conducting longitudinal studies spanning longer observation periods to capture cyclical and structural changes in capital structure determinants.
3. Additional mediating variables: Investigating other potential mediating factors such as corporate governance quality, environmental performance, or technological innovation capacity.
4. International comparative studies: Comparing capital structure relationships across different emerging markets to identify country-specific versus universal patterns.
5. Advanced measurement approaches: Utilizing more sophisticated measurement techniques, including market-based indicators and forward-looking metrics, to enhance the precision of variable measurement.
6. Regulatory impact assessment: Examining how specific regulatory changes and policy interventions affect capital structure relationships and organizational adaptation strategies.

These research directions would contribute to a more comprehensive understanding of capital structure determinants in emerging markets and enhance the practical relevance of academic findings for corporate decision-makers and policymakers.

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