

FRAMEWORK OF MULTI-THEORETICAL MECHANISMS IN FINANCIAL DISTRESS: THE INTERACTION BETWEEN FINANCIAL PRESSURE AND LIQUIDITY FAILURE



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ABSTRACT

Background: Increasing leverage and economic uncertainty heighten the risk of financial distress; however, the relationship between capital structure and distress remains inadequately explained by approaches that focus on individual determinants.

Objective: This study aims to develop an integrative multi-theoretical framework to explain financial distress as a causal process involving the interaction between financial pressure and liquidity capacity using a qualitative literature-based approach.

Method: This study adopts a qualitative literature-based approach by integrating trade-off theory, pecking order theory, and market timing theory, along with supporting theories such as agency theory and asymmetric information.

Findings: The results indicate that capital structure outcome generates financial pressure, placing firms in a pre-distress state. However, financial distress does not arise directly from leverage; rather, it occurs when financial pressure is not offset by sufficient liquidity capacity. Within this framework, working capital management functions as a corrective mechanism that determines whether financial pressure can be absorbed or escalates into distress through liquidity failure.

Conclusion: This study positions financial distress as an outcome of the interaction between financial pressure and liquidity capacity within a layered causal system, and identifies two implicit evolutionary paths: intervention through corrective mechanisms or progression toward a terminal pathway.

Originality: This study contributes theoretically by shifting the perspective from direct relationships toward a mechanism-based explanation, and by positioning working capital management as a key mechanism in the transformation of financial pressure into financial distress.

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INTRODUCTION

Financial distress is a critical issue in corporate finance, as it is closely linked to business continuity and the risk of bankruptcy. In recent years, the financial stability of the corporate sector has faced significant pressure due to rising leverage and tightening global financial conditions. Increases in global interest rates have raised borrowing costs and heightened corporate vulnerability,

particularly for highly leveraged firms (International Monetary Fund, 2023; Acharya et al. 2020). Moreover, empirical evidence shows that even firms with relatively strong fundamentals can experience financial pressure due to external shocks and liquidity constraints (Ding et al. 2021; Altman et al. 2019). In this context, financial distress is not solely driven by declining performance, but also by increasing financial pressure that is not matched by sufficient liquidity capacity.

In the national context, similar patterns can be observed among firms in Indonesia. Rising liquidity risk and post-pandemic corporate debt restructuring reflect growing pressure on operating cash flow amid monetary policy normalization (Bank Indonesia, 2023; Otoritas Jasa Keuangan, 2023). Studies in the Indonesian context suggest that vulnerability to financial distress is determined not only by leverage, but also by firms' ability to manage working capital and maintain cash flow stability (Gunawan, 2019; Firdaus and Nur'aidawati, 2024; Hassa and Azzardina, 2024). These findings are consistent with international evidence emphasizing the role of liquidity and financial flexibility in mitigating financial pressure (Campello et al. 2010; Almeida et al. 2014).

From a theoretical perspective, financial distress is commonly explained as a consequence of capital structure decisions, particularly through higher leverage that increases default risk (Modigliani and Miller, 1958; Kraus and Litzenberger, 1973; Myers, 1984). Within this framework, the relationship between capital structure and financial distress is typically treated as direct, where riskier capital structure outcomes are associated with higher probabilities of distress. However, this perspective does not fully explain how financial pressure arising from financing decisions is transformed into actual distress conditions (Frank and Goyal, 2009; Graham and Leary, 2011).

On the other hand, the literature on working capital management highlights the importance of liquidity management in maintaining firms' ability to meet short-term obligations (Shin and Soenen, 1998; Deloof, 2003; Aktas et al. 2015). More recent studies show that efficient working capital management is closely related to firms' resilience against financial pressure and distress risk (Baños-Caballero et al. 2020). Nevertheless, research on capital structure and working capital management has largely developed in parallel, leaving the interaction between financial pressure and liquidity capacity insufficiently integrated in explaining the emergence of financial distress.

Accordingly, a framework that integrates capital structure outcome, financial pressure, and liquidity capacity in explaining financial distress remains underdeveloped. This limitation highlights the need for an approach that goes beyond direct relationships and instead explains the underlying interaction mechanisms. This study proposes a framework that

positions financial distress as the outcome of the interaction between financial pressure and liquidity capacity within a dynamic and layered causal system. Specifically, financial distress is viewed not as a direct consequence of capital structure, but as the result of interacting mechanisms that shape the evolution of firms' financial conditions.

METHODS

This study employs a qualitative research design based on a structured literature review to develop a conceptual framework explaining financial distress as a mechanism-based process. The approach integrates key theoretical perspectives in corporate finance, including trade-off theory, pecking order theory, market timing theory, agency theory, and asymmetric information. Rather than testing hypotheses empirically, the study synthesizes existing theoretical and empirical findings to construct a layered causal explanation linking capital structure outcome, financial pressure, and liquidity capacity.

The literature search was conducted using major academic databases, primarily Scopus-indexed journals, supplemented by Google Scholar to ensure coverage of recent and relevant studies. The selection process followed a semi-systematic (PRISMA-inspired) approach, focusing on peer-reviewed articles published in reputable journals, particularly those addressing capital structure, financial flexibility, working capital management, and financial distress. Articles were included based on relevance to the proposed mechanism, methodological rigor, and citation impact, while studies with limited theoretical or empirical contribution were excluded. This approach ensures that the framework is grounded in high-quality and conceptually aligned literature.

RESULTS

Meta-Theory in Corporate Finance

The study of corporate financial decisions is grounded in the assumption of rationality as articulated in rational choice theory, which views individuals both managers and investors, as agents who seek to maximize utility based on available information (Fama, 1970). Within this framework, financial decisions are understood

as the outcome of selecting optimal alternatives by weighing the trade-off between risk and return.

This assumption is extended in the theory of the firm, which explains how individual decisions are articulated within organizational settings through contractual structures and agency relationships. Firms are viewed as value-creating entities, where financial decisions are shaped by interactions among managers, shareholders, and creditors (Jensen and Meckling, 1976; Hart, 1995). At the market level, the efficient market hypothesis posits that security prices reflect available information, implying that financial decisions are incorporated into prices and the cost of capital (Fama, 1970; Fama and French, 2004). In this context, markets function as information aggregation mechanisms that evaluate corporate decisions.

Taken together, these perspectives form the meta-theoretical foundation of corporate finance, representing the individual, organizational, and market levels in understanding financial decision-making.

Corporate Finance Theory and Capital Structure Theory as Grand Theory

At the grand theory level, corporate finance theory provides a conceptual framework for understanding how firms make investment and financing decisions to maximize firm value. Within this framework, financing decisions play a central role, as they determine the choice of funding sources that influence the cost of capital and the firm's risk profile (Fama and French, 2004; Jensen and Meckling, 1976).

As a more specific elaboration, capital structure theory focuses on the determination of the debt–equity mix and its implications for risk and the cost of capital. Its foundation lies in the propositions of Modigliani and Miller, which suggest that under perfect market conditions, capital structure is irrelevant to firm value (Modigliani and Miller, 1958).

As these assumptions are relaxed, various market frictions such as taxes, bankruptcy costs, asymmetric information, and agency conflicts emerge, making capital structure relevant in practice. In this context, the concept of an optimal capital structure develops as a framework for understanding how financing choices relate to the cost of capital and firm risk (Myers, 1984; Kraus and Litzenberger, 1973).

Thus, corporate finance theory provides the general framework for understanding financing decisions, while capital structure theory offers a more focused perspective on how variations in capital structure shape firms' risk and cost of capital.

Development of Capital Structure Theory (Middle-Range Theory)

At the middle-range level, variations in capital structure reflect different decision logics operating under uncertainty and market frictions. In this context, the concept of an optimal capital structure serves as an analytical reference point that emerges as the assumptions of perfect markets are relaxed.

Several approaches have been developed to explain how firms determine their capital structure under such conditions. Trade-off theory emphasizes the balance between the benefits and costs of debt in determining leverage (Kraus and Litzenberger, 1973; Myers, 1984). Pecking order theory highlights hierarchical financing preferences as a consequence of asymmetric information (Myers and Majluf, 1984), while market timing theory underscores the role of market conditions in shaping financing decisions (Baker and Wurgler, 2002).

Beyond these decision-level models, the literature also emphasizes underlying mechanisms that drive financing behavior. Agency theory explains how conflicts of interest between managers and shareholders influence financial decisions (Jensen and Meckling, 1976), whereas asymmetric information highlights how information imbalances shape financing preferences.

Further developments introduce the perspective of dynamic capital structure, which views capital structure as adaptive and responsive to changes in firms' internal conditions such as profitability, cash flow, and investment needs and external conditions, including financing costs and market access (Flannery and Rangan, 2006; Huang and Ritter, 2009). In this view, financing decisions evolve gradually over time rather than being static.

Overall, this level provides multiple conceptual perspectives on how financing decisions are formed under imperfect conditions. The diversity of these approaches suggests that no single model can universally explain firms' financing behavior.

Financial Distress and Financial Implications (Applied Domain)

At the applied domain level, financial pressure associated with capital structure is reflected in operational liquidity dynamics through working capital management. Working capital management represents a firm's liquidity capacity in managing short-term assets and liabilities including cash, receivables, inventories, and payables to maintain a balance between liquidity and operational efficiency (Deloof, 2003; Shin and Soenen, 1998).

Financial distress refers to a condition in which firms face difficulties in meeting their financial obligations, typically characterized by constrained operating cash flow, declining performance, and an increased risk of default (Opler and Titman, 1994; Andrade and Kaplan, 1998).

If such conditions persist, they may evolve into bankruptcy as a terminal pathway (White, 1989). However, firms may also recover through various forms of adjustment under corporate restructuring (Hotchkiss et al. 2008).

Thus, the applied domain provides a basis for understanding how firms' financial conditions are manifested in liquidity management and in their response to financial pressure.

As illustrated in Figure 1, the relationships among theories are structured hierarchically. Meta-theory provides the conceptual foundation at the individual, organizational, and market levels, which is then extended into grand theory and middle-range theory to explain financial decision-making. These concepts are subsequently manifested at the applied domain through firms' operational dynamics. This structure highlights that each level plays a distinct role in explaining corporate financial phenomena, from foundational assumptions to operational outcomes.

Despite the extensive development of theories explaining capital structure decisions and their implications, existing approaches remain largely fragmented. In particular, capital structure, liquidity, and financial distress are often examined separately, leaving the relationship among capital structure outcome, financial pressure, and liquidity capacity insufficiently integrated within a coherent framework.

Therefore, this study proposes a mechanism-based approach that integrates multiple theoretical levels into a unified framework. Within this framework, financial distress is positioned as an outcome not only of financing decisions, but also of the interaction between financial pressure and liquidity capacity in the firm's operational context.

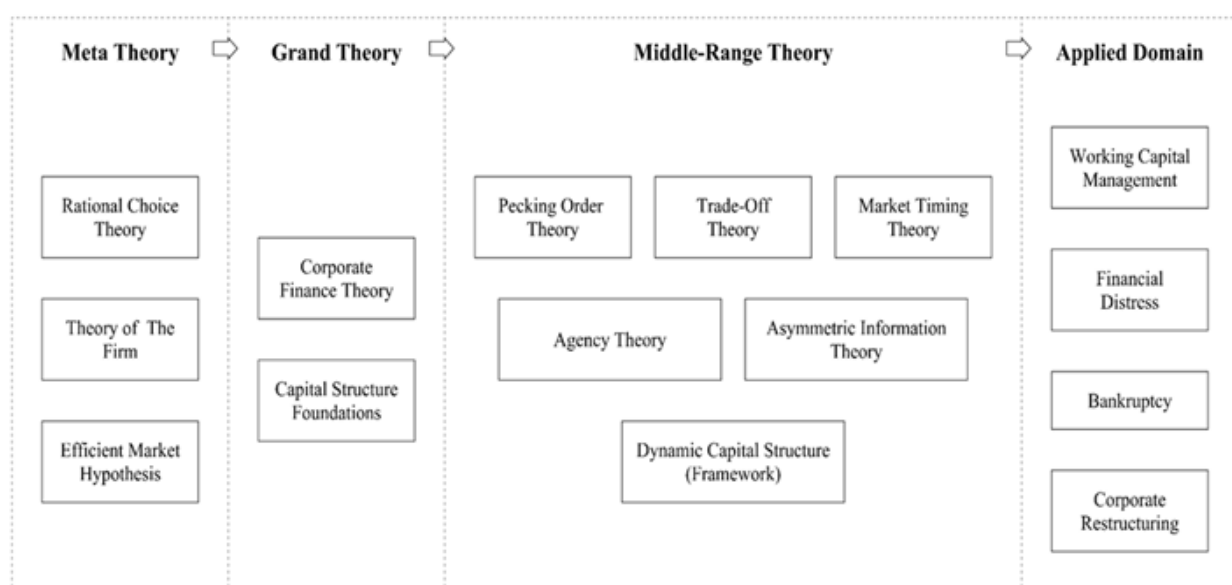


Figure 1. Theoretical architecture of the study

Capital Structure Outcome and Financial Pressure

The literature suggests that capital structure outcome, particularly through leverage and the cost of capital, is associated with higher fixed payment obligations, increasing firms' exposure to financial pressure (Kraus and Litzenberger, 1973; Myers, 1984; Frank and Goyal, 2009).

More recent empirical evidence suggests that capital structure influences financial flexibility and financing constraints, which in turn determine firms' ability to absorb financial shocks and meet their obligations (Choi et al. 2025; Satrio, 2025). This indicates that the implications of capital structure are not purely static but are closely linked to the dynamics of financial pressure faced by firms. Accordingly, capital structure outcome can be understood as a key source of financial pressure that firms must manage in their operations.

1. Liquidity Mechanism and the Role of Working Capital Management

While financial pressure is related to capital structure, the literature shows that liquidity capacity plays a crucial role in determining whether such pressure develops into financial distress. Firms with stronger liquidity positions are generally better able to maintain financial stability under obligation pressure (Habib et al. 2020).

In this context, working capital management reflects firms' operational ability to manage short-term liquidity. Efficient management of receivables, inventories, and payables is associated with greater financial flexibility and cash flow stability (Deloof, 2003; Baños-Caballero et al. 2020). However, most studies treat liquidity as a static determinant rather than a dynamic response mechanism. From a mechanism perspective, liquidity is better understood as a corrective mechanism that shapes firms' ability to respond to financial pressure at the pre-distress state.

2. Dynamic Capital Structure and Adjustment Process

Beyond structural and operational factors, the relationship between capital structure and financial distress is inherently dynamic. Firms actively adjust their financing policies in response to changes in internal conditions, such as profitability, cash flow, and

investment needs and external conditions, including financing costs, market access, and liquidity constraints (Flannery and Rangan, 2006; Huang and Ritter, 2009). Under financial pressure, firms tend to adjust their capital structure to maintain financial flexibility and reduce default risk. This process reflects gradual adjustment toward target leverage, constrained by adjustment costs and market frictions. However, the literature often treats this process as a partial response, without explicitly linking it to the effectiveness of liquidity management. In practice, the interaction between capital structure adjustment and liquidity capacity plays a key role in shaping the evolution of firms' financial conditions over time.

3. Determinants of Financial Distress and Empirical Limitations

Empirical studies show that financial distress is influenced by multiple factors, including leverage, profitability, liquidity, and corporate governance (Habib et al. 2020; Altman et al. 2019), as well as macroeconomic conditions and financing constraints (García-Appendini and Montoriol-Garriga, 2021; Acharya et al. 2020). However, financial distress is typically treated as a final outcome of these factors, with limited attention to the underlying transition process. From a mechanism perspective, financial distress is better understood as the result of the interaction between financial pressure and liquidity capacity, particularly when firms can no longer maintain liquidity balance under increasing financial obligations.

4. Empirical Synthesis and Research Gap

Overall, the empirical literature suggests three key patterns. First, capital structure outcome contributes to the formation of financial pressure through leverage and the cost of capital. Second, liquidity capacity, reflected in working capital management, plays a critical role in determining firms' ability to absorb and respond to financial pressure (Baños-Caballero et al. 2020; Aktas et al. 2015). Third, the dynamic capital structure perspective indicates that financial pressure evolves gradually as firms adjust to changing conditions. Third, the dynamic capital structure perspective indicates that financial pressure evolves gradually as firms adjust toward target leverage under adjustment frictions (Dang et al. 2019; DeAngelo and Roll, 2015).

Despite these insights, the existing literature largely treats these factors as separate determinants. As a result, the interaction between financial pressure and liquidity capacity remains insufficiently integrated in explaining financial distress.

This study therefore proposes an integrative framework that links capital structure outcome, working capital management, and financial distress within a dynamic causal mechanism.

Framework and Analysis

The theoretical framework of this study constructs a hierarchical causal structure across financial theories to explain financial distress as a process rather than a static outcome. These theories are organized into four levels: meta-theory, grand theory, middle-range theory, and applied domain; which collectively explain how financial decisions translate into financial pressure and, under certain conditions, evolve into distress.

In contrast to conventional approaches that emphasize direct relationships among variables, this study positions financial distress as the result of interacting mechanisms involving capital structure outcome and liquidity dynamics. Within this framework, capital structure outcome is associated with the formation of financial pressure that places firms in a pre-distress state, while liquidity capacity acts as a corrective mechanism that shapes how such pressure evolves. Accordingly, the focus shifts from associative relationships to a mechanism-based explanation of the transition toward distress.

Causal Relationships at the Meta-Theory Level

At the meta-theory level, rational choice theory posits that individuals, both managers and investors, act as rational agents seeking to maximize utility through optimal financial decisions (Fama, 1970; Jensen and Meckling, 1976). This provides a micro-foundation for understanding how financing, investment, and liquidity decisions are made under resource constraints and uncertainty.

The theory of the firm extends this perspective by explaining how such decisions are articulated within organizational settings through contractual structures and agency relationships that shape corporate financial

policies (Jensen and Meckling, 1976; Hart, 1995). In this view, capital structure decisions reflect not only rational preferences but also interactions among shareholders, managers, and creditors.

At the environmental level, the efficient market hypothesis suggests that these decisions are reflected in security prices and the cost of capital through information-efficient market mechanisms (Fama, 1970; Fama and French, 2004). Thus, markets function as information aggregation mechanisms that translate internal corporate decisions into external outcomes.

Together, these foundations form a hierarchical causal structure: rational choice theory provides the behavioral basis, the theory of the firm articulates decisions within organizations, and the efficient market hypothesis explains how these decisions are validated through market mechanisms. The central focus at this level is on how financial decisions are formed and evaluated within the economic system.

Causal Relationships at the Grand Theory Level

Building on the meta-theoretical foundation, corporate finance theory at the grand theory level integrates individual rationality, organizational mechanisms, and market efficiency in explaining corporate financial decisions. Investment, financing, and dividend decisions are understood as outcomes of optimization processes aimed at maximizing firm value under various frictions, such as asymmetric information, contractual constraints, and market conditions (Fama and French, 2004; Jensen and Meckling, 1976).

Within this framework, financing decisions become central, as they determine the firm's risk profile and cost of capital, forming the basis for understanding the structural implications of corporate financial policies.

Capital structure theory further specifies how firms determine the mix of debt and equity. Its foundation lies in the Modigliani and Miller propositions, which serve as an analytical benchmark by demonstrating that, under perfect market conditions, capital structure is irrelevant to firm value (Modigliani and Miller, 1958). The relevance of capital structure emerges as these assumptions are relaxed, introducing frictions such as taxes, bankruptcy costs, asymmetric information, and agency conflicts.

Under these conditions, theory evolves toward the concept of an optimal capital structure, defined as a trade-off between the benefits and costs of debt (Kraus and Litzenberger, 1973; Myers, 1984; Myers and Majluf, 1984; Frank and Goyal, 2009).

However, the literature largely focuses on determining optimal leverage without explicitly linking these structural implications to broader financial dynamics. In this context, capital structure outcome can be understood as a representation of financing decisions that capture the firm's risk and funding conditions, forming the basis for explaining variations in financing behavior at the middle-range level.

Causal Relationships at the Middle-Range Theory Level

At the middle-range level, the relationships among theories form a layered system consisting of decision-level models, underlying causal mechanisms, and a dynamic adjustment mechanism. This structure bridges the abstraction of grand theory with observable variations in firms' financing behavior by explaining how financing decisions are formed, shaped by

fundamental drivers, and adjusted over time. To clarify the interactions across theories at this level, Figure 2 illustrates the relationship between decision-level models and underlying mechanisms in explaining variations in capital structure decisions.

Decision-Level Models in Capital Structure

At the first layer, trade-off theory, pecking order theory, and market timing theory function as decision-level models that explain how firms determine their capital structure. These approaches represent distinct and often competing decision logics. Trade-off theory assumes the existence of an optimal target leverage determined by balancing tax benefits against bankruptcy and agency costs. In contrast, pecking order theory rejects the notion of a target and views capital structure as the cumulative outcome of financing decisions driven by asymmetric information. Meanwhile, market timing theory emphasizes the role of market conditions in shaping financing choices. These differences suggest that no single model universally explains financing behavior; rather, each operates within a conditional domain of validity.

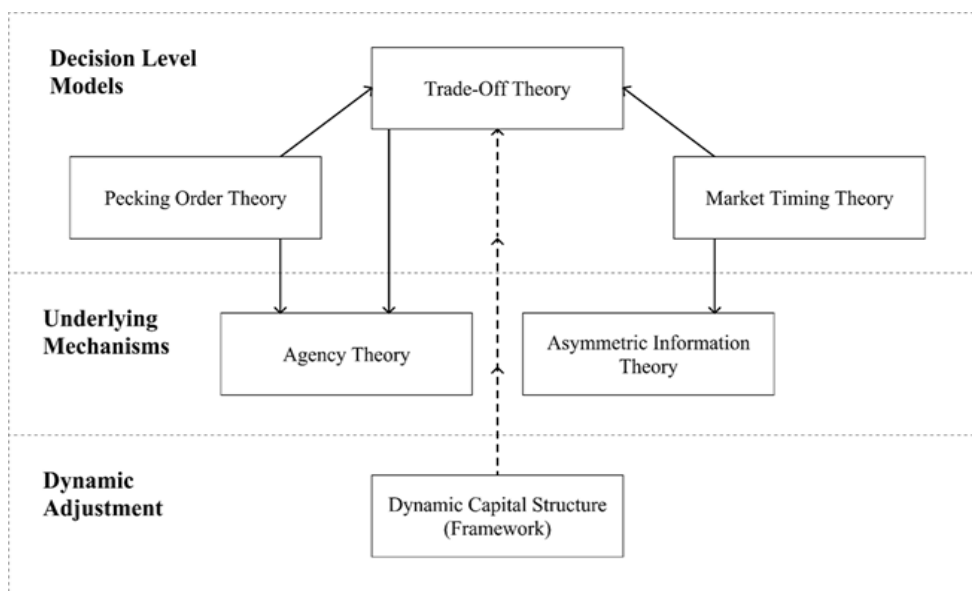


Figure 2. Interactions across theories at the middle-range level in explaining capital structure decisions

Underlying Causal Mechanisms in Capital Structure Decisions

At the second layer, agency theory and asymmetric information serve as underlying causal mechanisms that explain the origins of variation in financing decisions. Agency theory highlights how conflicts of interest among managers, shareholders, and creditors shape preferences for debt usage. Asymmetric information explains how information imbalances affect the cost of external financing and influence financing preferences. Within this framework, decision-level models can be understood as behavioral manifestations of more fundamental causal mechanisms.

Dynamic Capital Structure as a Dynamic Adjustment Mechanism

At the third layer, the dynamic capital structure perspective introduces a temporal dimension to financing decisions. Unlike static approaches, it emphasizes that firms adjust their capital structure gradually, taking into account adjustment costs and changes in internal conditions (e.g., profitability, cash flow, investment needs) and external conditions (e.g., financing costs and market access) (Flannery and Rangan, 2006; Huang and Ritter, 2009). This process reflects that financing decisions are not static but evolve over time through a dynamic adjustment mechanism.

Capital Structure Outcome as a Source of Financial Pressure

The interaction among underlying mechanisms, decision-level models, and the dynamic adjustment mechanism results in capital structure outcome, reflecting leverage, financing composition, and implications for the cost of capital. While often treated as an outcome or explanatory variable in empirical models, its broader implications remain insufficiently integrated. In this context, capital structure outcome can be viewed as a critical link connecting financing decisions to broader financial conditions through the formation of financial pressure.

Causal Relationships at the Applied Domain

Working Capital Management as a Corrective Mechanism

At the applied domain level, working capital management functions as an operational implementation and transmission mechanism linking capital structure outcome to short-term liquidity dynamics. Through this mechanism, financial pressure arising from fixed payment obligations due to leverage and the cost of capital is reflected in liquidity capacity through the management of receivables, inventories, and payables. From a mechanism perspective, working capital management not only reflects liquidity conditions but also acts as a corrective mechanism shaping firms' ability to respond to financial pressure at the pre-distress state. Efficient management enhances financial flexibility and reduces reliance on external financing, whereas inefficiencies increase liquidity pressure. Thus, the relationship between capital structure and liquidity is mediated by firms' operational capacity to manage the cash conversion cycle.

Financial Distress as the Outcome of Mechanism Failure

Financial distress arises when firms are unable to meet their financial obligations due to insufficient liquidity. While higher leverage increases financial pressure, it does not necessarily lead to distress if firms maintain adequate liquidity capacity. Instead, liquidity failure that is reflected in inefficient working capital management acts as the mechanism through which financial pressure escalates into distress (Opler and Titman, 1994; Andrade and Kaplan, 1998). Accordingly, financial distress is not simply a direct function of leverage, but an outcome of limitations in the corrective mechanism in responding to financial pressure. This perspective shifts the focus from linear relationships to a mechanism-based explanation of the transition from pre-distress state to distress.

Terminal and Corrective Mechanisms: Bankruptcy vs. Restructuring

If financial distress cannot be mitigated, firms may move toward bankruptcy, where liquidity failure becomes the primary trigger of default (White, 1989). In this framework, bankruptcy represents a terminal

pathway the endpoint of financial pressure that can no longer be absorbed by liquidity capacity. However, not all distress leads to bankruptcy. Firms may undertake corporate restructuring to restore financial balance (Hotchkiss et al. 2008). In this context, restructuring acts as an extended corrective mechanism that addresses imbalances between financial pressure and liquidity capacity through adjustments in liabilities and operational improvements. Working capital management plays a central role in stabilizing operating cash flow and restoring liquidity. Thus, the system reflects two possible evolutionary paths: recovery through corrective mechanisms or failure leading to a terminal pathway.

Causal Integration and Theoretical Contribution

Overall, the applied domain translates the mechanisms developed at prior levels into observable financial dynamics. Capital structure outcome generates financial pressure that places firms in a pre-distress state, while working capital management determines the firm's ability to respond. Financial distress emerges when this response is insufficient, and subsequent outcomes depend on whether firms can restructure or move toward bankruptcy. Unlike prior literature that separates financing and liquidity management, this framework integrates them within a unified causal system. By linking decision-level models, underlying mechanisms, dynamic adjustment, and operational implementation, this study positions financial distress as the result of layered and dynamic interactions rather than a direct consequence of capital structure.

Research Propositions

Based on the integrated framework, financial distress is understood as the outcome of a layered causal system involving decision-level models, underlying mechanisms, dynamic adjustment, and operational implementation. Capital structure is not treated as a direct determinant but as a source of financial pressure that places firms in a pre-distress state, which interacts with liquidity capacity to shape financial outcomes.

P1: Financial Pressure as a Consequence of Capital Structure Outcome. Capital structure outcome, reflected in leverage and cost of capital, generates financial pressure through increased fixed obligations and risk exposure, forming the initial pre-distress state.

P2: Working Capital Management as a Transmission Mechanism. The effect of capital structure outcome on financial distress is not direct but operates through working capital management as an operational implementation mechanism reflecting firms' liquidity capacity.

P3: Core Mechanism: Interaction between Financial Pressure and Liquidity Capacity. Financial distress arises from the interaction between financial pressure and liquidity capacity. It occurs when financial pressure is not offset by sufficient liquidity, leading to liquidity failure. Thus, the key mechanism lies not in leverage itself, but in the limitations of the corrective mechanism at the pre-distress state.

P4: Moderating Role of Working Capital Management. Working capital management moderates the relationship between financial pressure and financial distress. Strong liquidity capacity mitigates pressure, while weak liquidity accelerates the transition toward distress.

P5: Dynamic Adjustment as a Temporal Dimension. From a dynamic capital structure perspective, financial pressure evolves over time. Adjustment processes influence the intensity and speed of pressure accumulation, shaping whether firms remain in a pre-distress state or move toward failure.

P6: Underlying Mechanisms as Contextual Conditions. The strength of the relationship among financial pressure, liquidity capacity, and financial distress is conditional on underlying mechanisms such as agency conflicts, asymmetric information, and market conditions.

Propositional Synthesis

Financial distress is not a direct consequence of capital structure but an outcome of the interaction between financial pressure and liquidity capacity within a dynamic and contextual causal system. Conceptually, this framework suggests two evolutionary paths: successful response through corrective mechanisms or progression toward failure. By integrating multiple theoretical levels, this study provides a more comprehensive explanation of the distress formation process. To synthesize the proposed relationships, Figure 3 presents the integrated mechanism through

which financial distress emerges from the interaction between financial pressure and liquidity capacity. Capital structure outcome generates financial pressure, while working capital management reflects liquidity capacity which, when insufficient, leads to liquidity failure. These components interact within the pre-distress state as a transitional condition toward financial distress. Thus, financial distress is understood not as a direct consequence of capital structure, but as the result of the interaction between financial pressure and liquidity capacity within the firm's operational domain. This framework highlights the importance of a mechanism-based approach that integrates financing decisions and liquidity dynamics.

CONCLUSIONS

This study develops a hierarchical conceptual framework that integrates multiple corporate finance theories to explain financial distress as a causal process rather than a static outcome. At the meta-theory and grand theory levels, individual rationality, organizational mechanisms, and market efficiency provide the foundation for corporate finance theory. This foundation is extended at the middle-range level through the interaction of underlying causal mechanisms (e.g., agency conflicts and asymmetric information), decision-level models (trade-off, pecking order, and market timing), and dynamic adjustment mechanisms.

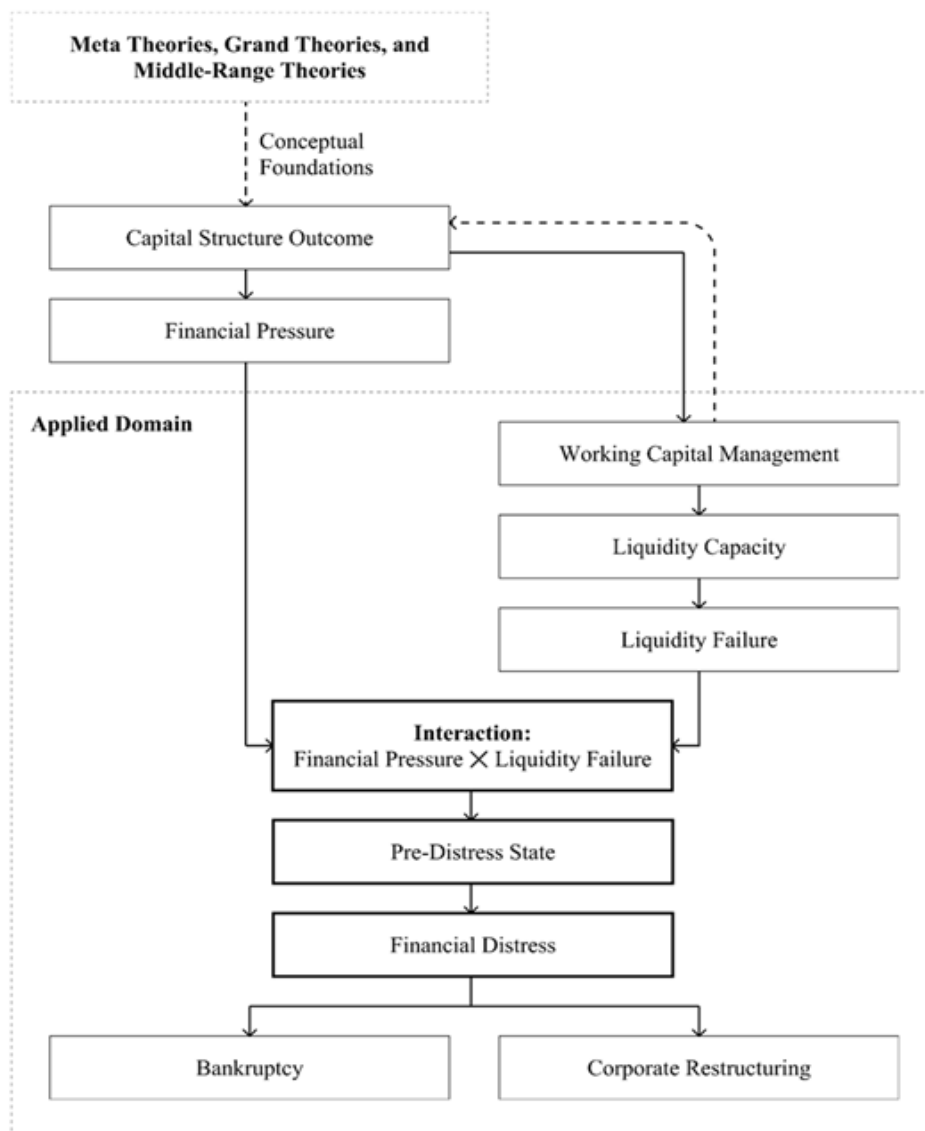


Figure 3. Integrated mechanism of financial distress: interaction between financial pressure and liquidity capacity

These layered interactions produce capital structure outcomes that are reflected in leverage and cost of capital which in turn generate financial pressure and place firms in a pre-distress state. The findings indicate that such pressure does not automatically lead to distress; rather, it depends on liquidity capacity, as reflected in working capital management as an operational implementation mechanism.

The main contribution of this study lies in shifting the perspective from direct relationships toward interacting mechanisms, where financial distress is understood as the outcome of an imbalance between financial pressure and liquidity capacity. Within this framework, liquidity failure serves as the key mechanism through which financial pressure escalates into distress.

Furthermore, financial distress is conceptualized as a transitional stage within a dynamic system, implying two possible evolutionary paths: successful intervention through corrective mechanisms allowing recovery via corporate restructuring or limited response leading toward a terminal pathway (bankruptcy). In this context, working capital management functions not only as an operational mechanism but also as a corrective instrument that shapes the evolution of firms' financial conditions.

Overall, this study emphasizes that financial distress is not a direct consequence of capital structure, but the result of dynamic interactions between financial pressure and liquidity capacity within a layered and contextual causal system.

Limitations

This study has several limitations. First, the proposed framework is conceptual and has not been empirically tested, so the strength of the proposed relationships cannot yet be quantitatively verified. Second, the focus on integrating corporate finance theories limits the exploration of broader external factors, such as macroeconomic conditions, institutional environments, and corporate governance. Third, working capital management is treated in aggregate, without distinguishing the relative contributions of specific components such as cash, receivables, and inventories.

Future Research

Future research should develop and empirically test models based on this framework, particularly

by positioning working capital management as a mediating mechanism between capital structure outcome and financial distress. Further studies should also incorporate contextual factors such as market conditions, corporate governance, and industry characteristics to examine the conditional nature of the proposed relationships.

The development of dynamic models is also important to capture the interaction between capital structure adjustment and liquidity over longer time horizons. Finally, future research may extend this framework by incorporating additional risk dimensions, such as governance failure or fraud risk, to enrich the understanding of distress formation mechanisms in more complex settings.

DECLARATIONS OF GENERATIVE AI USE:

This study makes limited use of generative artificial intelligence to improve clarity and presentation quality. All conceptual development, analysis, and interpretation remain the sole responsibility of the author.

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