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THE EFFECT OF FINANCIAL PERFORMANCE, INTEREST RATES, INFLATION, AND EXCHANGE RATES ON FINANCIAL DISTRESS

Irwan Moridu*, Nurcahya Hartaty Posumah

Study Program of Management, Faculty of Economics and Business, Universitas Muhammadiyah Luwuk
Jl. KH. Ahmad Dahlan No.III/79 Luwuk, Banggai Regency, Central Sulawesi Province, 94711, Indonesia

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Abstract:

Background: A persistent deterioration in corporate financial performance may signal the emergence of financial distress. Identifying the factors associated with this condition is therefore important to enable appropriate preventive measures.
Purpose: This study investigates if financial hardship among manufacturing companies in the different industrial sectors listed on the Indonesia Stock Exchange between 2017 and 2022 is influenced by Return on Assets (ROA), interest rates, inflation, and exchange rates.
Design/methodology/approach: Panel regression analysis and a quantitative research approach are used in the study. Purposive sampling was used to choose the 75 observations that make up the sample. Descriptive analysis, panel regression, classical assumption testing, model selection, hypothesis testing, and the coefficient of determination were all used in the EViews 12 data processing.
Findings/Results: According to the empirical data, financial distress is significantly positively correlated with ROA and interest rates, but not with inflation or exchange rates. Numerous theoretical stances can be used to interpret the results. Trade-off Theory suggests that rising financing and interest costs may increase bankruptcy risk. ROA may also signal weaknesses in asset efficiency or liquidity when profitability is insufficient to offset financial obligations. Signaling Theory explains how changes in ROA can convey information about corporate financial conditions to investors and creditors. In addition, Pecking Order Theory suggests that changes in financing costs may alter firms' funding choices and, consequently, affect financial distress risk. The coefficient of determination is 0.874477, equivalent to 87.44%. Thus, ROA, interest rates, inflation, and exchange rates collectively explain 87.44% of the variation in financial distress among the sampled companies, with the remaining proportion attributable to factors outside the model.
Conclusion: The results may assist managers of manufacturing companies in identifying early warning indicators and taking corrective measures before financial difficulties develop into more severe financial distress or potential bankruptcy.
Originality/value (State of the art): A decline in a company's financial situation that may occur when the business finds it difficult to fulfilll its immediate obligations is referred to as financial distress.

Keywords: ROA, interest rate, inflation, exchange rate, financial distress

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* Corresponding author:
Email: irwanmoridu@gmail.com

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INTRODUCTION

Annual financial statements provide information for evaluating a firm's performance, financial position, and changes in financial condition, and support investment decisions (Arista & Serly, 2023). Investors are generally more willing to allocate funds to publicly listed companies when the available information suggests favorable prospects. Company value is closely associated with perceived quality, credibility, and future performance (Dini et al. 2023). A stronger company value can reinforce investor confidence because it reflects expectations regarding the firm's performance and prospects. Financial health can be assessed using information reported in financial statements (Rahman et al. 2024). One important warning sign is financial distress, which occurs when a company faces serious financial difficulty and becomes less able to meet its obligations (Utomo et al. 2025). Insufficient capital, excessive debt, and persistent losses are among the factors that may contribute to such conditions (Lienanda & Ekadjaja, 2019).

Profitability is an important indicator of corporate financial health and can influence the decisions of investors and creditors (Rauhaty, 2021, as cited in Ginoga et al. 2025). A profitability indicator called return on assets (ROA) gages how well a business uses its assets to produce profits. Changes in company performance may influence investors' willingness to invest and, in turn, affect firm value (Indriyani, 2016). For this reason, maintaining sound financial performance is important because it is considered by prospective investors when assessing investment opportunities (Muliadi, 2022). Movements in share prices can subsequently influence the market value of issuers (Wulandari et al. 2020). Investor confidence may also be affected by movements in interest rates. Higher rates can reduce the attractiveness of corporate investment, whereas lower rates may encourage investment activity (Achmadi, 2023).

Exchange rates represent another external factor that may be associated with financial distress through their effects on corporate performance and stock values (Elsandi & Sufina, 2023). Generally speaking, supply and demand affect the exchange rate, which shows how much domestic currency is needed to obtain a unit of foreign currency (Wafi et al. 2021). Changes in macroeconomic conditions can influence stock prices and investors' decisions, thereby creating a possible link between exchange-rate movements and financial distress (Dwijayanti, 2021). Exchange-rate conditions are also relevant to capital flows and investor interest (Kurniawan & Yuniati, 2019). Stable economic growth, relatively low interest rates, and a stable rupiah against the US dollar can support foreign investment in Indonesia (Apriliana & Soebagiyo, 2023).

The research model brings together one internal profitability indicator and three macroeconomic indicators. ROA is used to assess the extent to which company assets generate earnings; a larger ratio generally indicates more effective utilization of assets (Mesrawati et al. 2022). Interest rates represent the financing cost associated with borrowed funds. Changes in rates can influence funding choices, investment returns, investment activity, and stock prices. Lower borrowing costs may consequently create stronger incentives to invest (Sudaryo et al. 2019).Inflation is considered because movements in the general price level affect real returns and purchasing capacity. Persistent increases in prices can raise operating expenses and weaken demand, which may subsequently affect company revenue and market valuation (Salim et al. 2021). Inflation is therefore relevant to both corporate planning and monetary policy. Interest-rate adjustments are among the instruments available to Bank Indonesia when responding to inflationary pressure and maintaining price stability.The exchange rate is included because currency movements affect the domestic-currency value of international transactions (Wafi et al. 2021). Such changes can influence decisions concerning production, investment, pricing, and other business activities. The issue is particularly relevant to export-oriented firms because fluctuations between the rupiah and US dollar can alter the value of foreign revenues and costs (Sartika & Choiriyah, 2019).

Inflation is the third variable considered in the study. Rising inflation can reduce real investment returns and weaken purchasing power. Lower inflation may provide a more favorable signal for investors. If inflation reduces company revenues, the market may respond negatively by driving down share prices (Salim et al. 2021). Because persistent price increases can affect households, businesses, and government activities, inflation is also an important macroeconomic variable. One policy response available to Bank Indonesia is to adjust interest rates to help maintain price stability.

The final external variable is the exchange rate, which is relevant to both international trade and investment transactions (Wafi et al. 2021). It reflects the interaction between demand for and supply of the rupiah and foreign currencies. A weakening rupiah can affect different economic groups, including government institutions, investors, and corporations. For companies, exchange-rate movements can influence production, marketing, investment, and other operating decisions. In export-oriented industries, movements in the rupiah against the US dollar may directly affect profitability (Sartika & Choiriyah, 2019).

The empirical procedure is organized into four steps. The first identifies the financial-distress condition through the Altman Z-Score, a bankruptcy-risk measure based on several financial indicators. The second collects data from manufacturing companies listed on the Indonesia Stock Exchange for the years 2017–2022 about ROA, interest rates, inflation, exchange rates, and financial hardship.The third estimates the proposed relationships using panel regression. The final step evaluates the estimated effects by examining coefficient direction and statistical significance.

The goal of the study is to ascertain whether changes in ROA, interest rates, inflation, and exchange rates among manufacturing companies from different industrial sectors listed on the Indonesia Stock Exchange between 2017 and 2022 are linked to financial distress.

METHODS

The research uses a quantitative descriptive design. The required corporate observations were obtained through documentation and observation of information published by the Indonesia Stock Exchange (IDX). The study relies on secondary observations drawn from company financial statements available throughout the 2017–2022 observation period. These reports provide the financial measures used in the empirical testing.

The observations cover 75 companies from various industry sectors. Selection was conducted purposively according to predetermined requirements, with particular attention to the completeness and continuity of the financial information needed for the research variables. Data processing was conducted with EViews 12 using panel regression under the Random Effects Model (REM). The specification contains one dependent construct and four explanatory variables. The statistical procedures comprise descriptive analysis, correlation assessment, classical-assumption diagnostics, selection of the appropriate panel specification, R^2 analysis, the simultaneous F-test, and partial t-tests.

Hypothesis

Effect of ROA on Financial Distress: Financial performance indicates how effectively management manages corporate resources and finances. Financial reports also serve as an important source of information for investors because they show how the company manages its resources. ROA is one indicator used to assess the effectiveness of asset utilization, and a relatively high ROA is commonly interpreted as evidence of stronger performance. Although Kartika and Hasanudin (2019) reported a negative relationship between ROA and financial distress, this study proposes a different direction. Therefore, the first hypothesis is: H1: ROA has a significant positive effect on financial distress.

Effect of Interest Rates on Financial Distress: Interest-rate policy is used by Bank Indonesia to maintain monetary and exchange-rate stability. Changes in interest rates can affect corporate financing conditions as well as the cost of imported inputs and business activities. Higher financing and production costs may eventually weaken consumer purchasing power, reduce business activity, and lower company revenue. Rohiman (2019) reported that interest rates were related to financial difficulties, although the effect was not significant, while Sudaryo et al. (2019) found no significant relationship. Based on the proposed research model, the second hypothesis is: H2: Interest rates have a significant positive effect on financial distress.

Effect of Inflation on Financial Distress: Persistent inflation may increase the cost of acquiring production inputs and capital goods. At the same time, weaker demand can make it more difficult for firms to distribute products. Higher production costs may subsequently reduce revenue and increase financial pressure. Inflation can also contribute to currency depreciation and reduce foreign investors' interest in the domestic capital market. Pertiwi (2018) reported a negative relationship between inflation and financial distress, whereas Wafi et al. (2021) obtained a positive relationship. Accordingly, the third hypothesis is: H3: Inflation has a positive effect on financial distress.

Effect of Exchange Rates on Financial Distress: Exchange-rate movements are determined by the interaction between demand for and supply of domestic and foreign currencies. A weakening rupiah may be associated with broader economic pressures and can influence investment conditions in the capital market. A relatively stable exchange rate is expected to support a more predictable business environment and corporate performance. Currency stability can also improve investor confidence regarding the value and availability of invested capital. Wafi et al. (2021) found no effect of inflation on financial distress, whereas according to Natasa et al. (2023), there is a weak but positive correlation between financial distress and exchange rates. Therefore, the fourth theory is: H4: Financial distress is positively impacted by exchange rates.

The theories and connections covered above serve as the foundation for the conceptual framework. It suggests a connection between financial turmoil and ROA, interest rates, inflation, and currency rates. In particular, each of the four explanatory variables is predicted by the model to have a positive connection. The framework is intended to clarify the relationships examined in the empirical analysis (Figure 1).

RESULTS

Descriptive Statistical Analysis

Financial distress has a mean of 3.624080 and a standard deviation of 2.240714, with observed values ranging from 0.385000 to 9.758000, according to Table 1's descriptive statistics. ROA has a mean of 0.299000, a standard deviation of 0.170174, and minimum and maximum values of 0.019000 and 0.811000. The interest rate ranges from 0.019000 to 0.922000, with a mean of 0.481613 and a standard deviation of 0.233075. Inflation ranges from 0.455000 to 3.835000, with a mean of 1.424307 and a standard deviation of 0.856610. The exchange rate, on the other hand, ranges from -0.260000 to 0.230000, with a mean of 0.080800 and a standard deviation of 0.076596. A mean of 3.624080 and a deviation of 2.240714. With a maximum of 9.758000 and a minimum of 3.624080.0.385000, this indicates that the average value of financial distress is somewhat high. ROA ranges from 0.811000 to 0.019000, with a mean of 0.299000 and a standard deviation of 0.170174. Interest rates have a mean of 0.481613, a standard deviation of 0.233075, and minimum and highest values of 0.019000 and 0.922000, respectively. Inflation has a mean of 0.481613, a standard deviation of 0.856610, a minimum and maximum of 0.019000 and 0.922000, respectively, 1.424307, and a minimum and maximum of 0.455000 and 3.835000.Meanwhile, the exchange rate has a standard deviation of 0.076596, a mean of 0.080800, and a minimum and maximum of -0.260000 and 0.230000, respectively.

Classical Assumption Test

Normality Test

Figure 2 reports a Jarque–Bera probability value of 4.940091. Because the reported value exceeds the 0.05 threshold used in the study, the data satisfy the normality assumption and are therefore suitable for subsequent panel regression analysis.

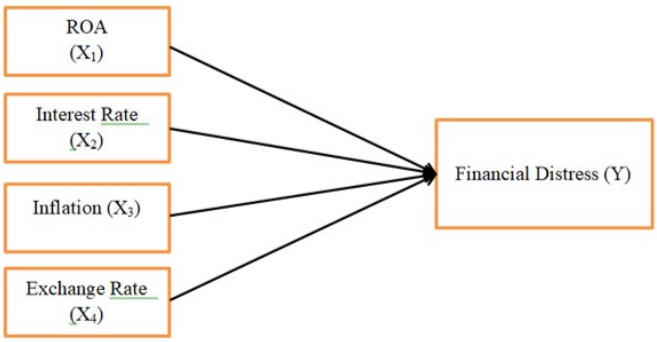


Figure 1. Framework

Multicollinearity Test

The multicollinearity check produces centered VIF values of 1.164496 for ROA, 1.276685 for interest rates, 1.053696 for inflation, and 1.207831 for the exchange rate (Table 2). Since none of these values approaches the stated threshold of 10, the model does not indicate problematic correlation among the independent variables.

Heteroscedasticity Test

The heteroscedasticity diagnostic returns probability values of 0.0217 for ROA, 0.0002 for interest rates, 0.0007 for inflation, and 0.8481 for the exchange rate (Table 3). Under the decision rule applied in the manuscript, the exchange-rate variable is the one identified as presenting the heteroscedasticity issue.

Table 1. Summary statistics of study measures

	ROA	Interest rate	Inflation	Exchange rate	Financial_Distress
Mean	0.299000	0.481613	1.424307	0.080800	3.624080
Median	0.305000	0.504000	1.156000	0.080000	3.136000
Maximum	0.811000	0.922000	3.835000	0.230000	9.758000
Minimum	0.019000	0.019000	0.455000	-0.260000	0.385000
Std. Dev.	0.170174	0.233075	0.856610	0.076596	2.240714
Skewness	0.479805	-0.394794	1.219081	-1.677415	1.092522
Kurtosis	3.235893	2.530509	3.625220	8.280982	3.644578
Jarque-Bera	3.051554	2.637097	19.79854	122.3239	16.21844
Probability	0.217452	0.267523	0.000050	0.000000	0.000301
Sum	22.42500	36.12100	106.8230	6.060000	271.8060
Sum Sq. Dev.	2.142968	4.019988	54.29974	0.434152	371.5392
Observations	75	75	75	75	75

Table 2. Variance inflation factor assessment

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	0.597383	3.62895	NA
ROA	1.382522	1.915327	1.164496
Interest rate	1.161189	2.912852	1.276685
Inflation	0.05962	1.788426	1.053696
Exchange rate	7.04057	1.487058	1.207831

Table 3. Variance consistency diagnostic

Dependent variable: Financial distress				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.33841	0.316584	4.227663	0.0001
ROA	-1.494895	0.636406	-2.348964	0.0217
Interest rate	1.988875	0.499137	3.984629	0.0002
Inflation	-0.451434	0.127004	-3.554474	0.0007
Exchange rate	-0.282191	1.467831	-0.19225	0.8481

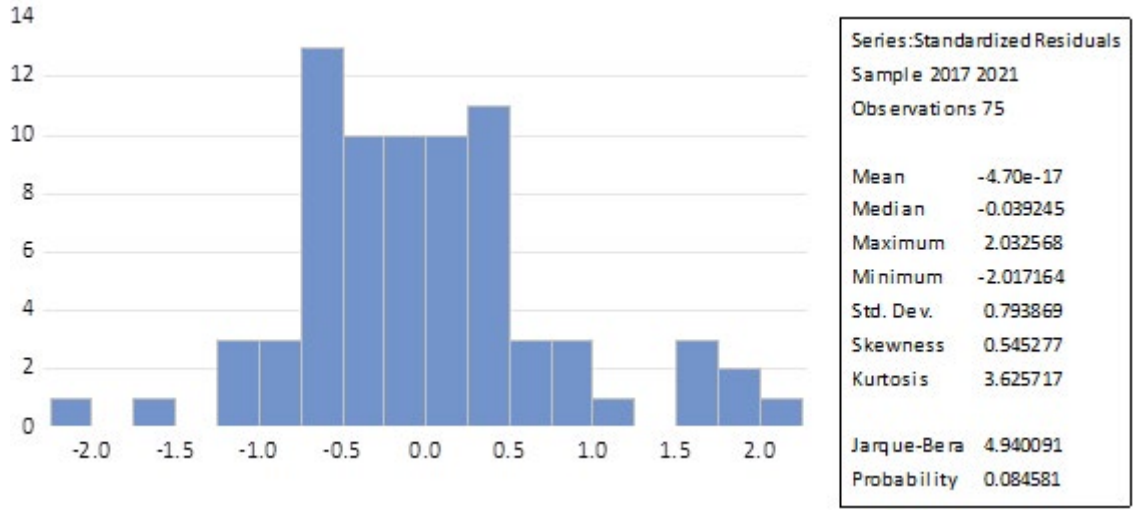


Figure 2. Normality Test

Autocorrelation Test

The regression produces a Durbin–Watson statistic of 1.425697 (Table 4). The reference values used in the decision process are dL = 1.5151, dU = 1.7390, and 4 − dU = 2.2610. Applying the criteria stated in the research, the model is interpreted as not experiencing autocorrelation.

Model Feasibility Analysis Results

Chow Test

The Chow specification test reports a probability of 0.0000, which is lower than the 0.05 criterion (Table 5). Consequently, the fixed-effects specification is favored at this stage and the Hausman procedure is required for the next model-selection decision.

Test Results

The p-value obtained from the Hausman test is 0.5192, which is greater than 0.05 (Table 6). This outcome permits the analysis to move on to the Lagrange Multiplier test and validates the application of the Random Effects Model.

Lagrange Multiplier Test Analysis

A cross-section probability of 0.0000 is obtained by the Lagrange Multiplier process (Table 7). The Random Effects Model is kept as the chosen panel-data specification since the result is less than 0.05.

Panel Regression Analysis

The following is the regression equation based on the data in Table 8:

$Y = \alpha - \beta1.X1 + \beta2.X2 + \beta3.X3 + \beta4.X4 + e$

Financial Distress = 0,208530258389 – 2,71773052742ROA + 9,2382723871Interest Rate – 0, 117234545034Inflation – 0,670124629778Exchange Rate + e

Hypothesis Testing

Simultaneous Test/ F Test

When the significance level for the F-test is less than 0.05, H0 is rejected, meaning that the explanatory factors together have a statistically significant association with the dependent variable. With a probability of 0.0000, the model yields an F-statistic of 21.67402 (Table 9). These findings suggest that financial suffering is significantly impacted by ROA, interest rates, inflation, and currency rates taken together.

Partial Test/ t-Test

The individual coefficient tests produce different conclusions. ROA has a probability of 0.0394 (Table 10), which satisfies the 0.05 criterion and therefore supports H1. Interest rates have a probability of 0.0000, providing support for H2. Inflation records a probability of 0.6699, so H3 is not supported. The exchange rate has a probability of 0.8177 and likewise fails to meet the significance criterion; consequently, H4 is rejected.

Table 4. Serial-Correlation Diagnostic

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.20853	0.774482	0.269251	0.7887
ROA	-2.717731	1.288113	-2.109855	0.0394
Interest rate	9.238272	1.260312	7.330145	0
Inflation	-0.117235	0.273591	-0.428503	0.6699
Exchange rate	-0.670125	2.893151	-0.231625	0.8177
Effects Specification				
Cross-section fixed (dummy variables)				
Root MSE	0.788558	R-squared	0.874477	
Mean dependent variable	3.62408	Adjusted R-squared	0.83413	
SD dependent var	2.240714	SE of regression	0.912579	
Akaike information criterion	2.869446	Sum squared residual	46.63682	
Black criterion	3.456543	Log likelihood	-88.60423	
Hannan-Quinn critter.	3.103867	F-statistic	21.67402	
Durbin-Watson stat	1.425697	Prob(F-statistic)	0	

Table 5. Fixed-versus-pooled specification test

Redundant Fixed Effects Tests			
Equation: Untitled			
Cross-section fixed effects test			
Effects Test	Statistics	df	Prob.
Cross-section F SS	11.314629	-14.56	0
Cross-section Chi-square	100.688563	14	0

Table 6. Hausman specification comparison

Correlated Random Effects - Hausman Test			
Equation: Untitled			
Cross-section random effects test			
Test Summary	Chi-Sq. Statistic	Chi-Sq. df	Prob.
Random cross-section	3.235335	4	.5192

Table 7. Random-effects selection test

	Hypothesis Testing		
	Cross section	Time	Both
Breusch Pagan	58.42488	1.071661	59.49654
	(.0000)	(.3006)	(.0000)

Table 8. Estimated random-effects regression

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.20853	0.774482	0.269251	0.7887
R OA	-2.717731	1.288113	-2.109855	0.0394
Interest rate	9.238272	1.260312	7.330145	0
Inflation	-0.117235	0.273591	-0.428503	0.6699
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Black criterion	3.456543	Log likelihood		-88.60423
Hannan-Quinn critter.	3.103867	F-statistic		21.67402
Durbin-Watson stat	1.425697	Prob(F-statistic)		0

Table 9. Overall model significance

F-statistic	21.67402
Prob(F-statistic)	.00000

Table 10. Variable-level significance

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.20853	0.774482	0.269251	0.7887
Roa	-2.717731	1.288113	-2.109855	0.0394
Interest rate	9.238272	1.260312	7.330145	0
Inflation	-0.117235	0.273591	-0.428503	0.6699
Exchange rate	-0.670125	2.893151	-0.231625	0.8177

Determination Coefficient Test (R^2)

The estimated coefficient of determination is 0.874477 (Table 11), equivalent to 87.44%. Accordingly, the explanatory variables included in the model account collectively for 87.44% of the variation in financial distress in the observed sample. The other 12.56% is associated with influences that are not represented in the current specification.

Interpretation of Empirical Findings

Influence ROA on Against Financial Distress

The empirical estimate shows that ROA has a positive and statistically significant relationship with financial distress, with a probability of 0.0394. This outcome may indicate that the assets held by the company are not necessarily generating returns efficiently. Inefficient allocation of resources or weaknesses in operational management can reduce the earnings obtained from the asset base. Limited margins can also leave asset-intensive firms with less capacity to absorb operating expenses and debt-service requirements. In addition, weak operating cash flow may restrict the funds available for daily activities and payment of obligations. When these conditions persist, investors and creditors may perceive greater financial vulnerability because the company appears less capable of generating adequate returns from its resources. The manuscript associates this result with Dirman (2020), although the description of that earlier evidence is inconsistent, while the finding differs from Holili et al. (2021), who reported no significant positive relationship between ROA and financial distress.

Table 11. Explained variation in financial distress

R-Square	0.874477
Adjusted R-Squared	0.834130

Influence of Interest Rates on Financial Distress

Interest rates have a positive and significant relationship with financial distress. One important mechanism is the increase in financing expenditure faced by firms that depend on debt. When borrowing becomes more expensive, a larger portion of available funds is used for interest payments, leaving less for operating activities. Continued increases in financing costs may consequently heighten financial vulnerability. Interest-rate changes can also influence aggregate demand because households and businesses experience different borrowing conditions, which can affect corporate sales. The financing environment may further shape investor and creditor behavior. If stakeholders believe that a firm has limited ability to absorb higher financing costs, external funding can become harder or more expensive to obtain. Higher rates may also reduce household purchasing power and weaken demand for company products. The finding is broadly related to Rohiman (2019), although the source discussion is inconsistent, and contrasts with Dwiyanti and Fauziyah (2023), who reported no significant effect.

When investors or creditors become less confident about a firm's ability to withstand a high-interest-rate environment, they may reduce or withdraw their funding, which can place additional pressure on the company's financial condition. Higher interest rates can also reduce household purchasing power because consumers face greater borrowing costs. The result is potentially weaker demand for corporate products. The finding is broadly related to Rohiman (2019). However, the original discussion describes the study inconsistently and differs from Dwiyanti and Fauziyah (2023), who found no significant effect of interest rates on financial distress.

Influence of Inflation on Financial Distress

The analysis does not identify a statistically significant effect of inflation on financial distress. A possible reason is that firms can respond to price movements through budgeting, cost adjustments, and operational planning. Selling prices may also be revised when production costs increase. If the market continues to absorb the revised prices, the effect on corporate revenue can remain limited. The result is consistent with Pertiwi (2018), but is different from the finding reported by Rohiman and Damayanti (2019).

Influence of Exchange Rates on Financial Distress

The exchange rate is not statistically significant in explaining financial distress. Firms with diversified markets can distribute currency exposure across several revenue streams, while hedging arrangements may further reduce the financial impact of exchange-rate changes. In addition, distress may be more strongly determined by internal financial conditions such as leverage, liquidity, profitability, and cash generation. Companies with adequate liquidity and operational flexibility can respond to currency movements through adjustments in pricing, costs, or production. The result is consistent with Natasa et al. (2023) and Setiyawan and Musdholifah (2020), but differs from Apriliana and Soebagiyo (2023).From a managerial perspective, the findings support regular monitoring of corporate financial conditions. ROA can be evaluated to determine whether assets are producing sufficient returns, while changes in interest rates should be incorporated into financing decisions. Investment choices should emphasize assets that can support sustainable earnings. Nevertheless, because previous studies have produced mixed evidence, management should not rely on ROA or interest rates alone when identifying financial-distress risk. Internal financial indicators and external economic developments should be assessed together.

From a managerial perspective, companies should strengthen financial management practices to reduce the likelihood of financial distress. Regular monitoring of ROA can help management assess whether corporate assets are generating adequate returns, while effective interest rate management can reduce exposure to rising financing costs. Management can also formulate investment strategies that improve asset productivity and strengthen profitability. Nevertheless, because previous studies do not consistently report significant effects for ROA and interest rates, managers should not rely on these indicators alone. Other internal and external financial factors should also be considered when making strategic decisions.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

The study concludes that ROA and interest rates have a positive effect on financial distress. In contrast, inflation and exchange rates do not show significant effects among companies in the various industry sectors during 2017–2022. The findings can be related to several theoretical perspectives. Trade-off Theory suggests that higher interest expenses and debt costs may increase the probability of financial difficulty. The relationship involving ROA may reflect limitations in asset efficiency or the inability of asset-generated returns to offset liabilities and liquidity pressures. From a signaling perspective, changes in ROA can provide investors and creditors with information about corporate financial conditions; in some circumstances, a relatively high ROA may coexist with elevated risk, such as high leverage. Pecking Order Theory also suggests that changes in financing costs can influence firms' choices among available sources of funding and, consequently, affect the risk of financial distress.

Recommendations

The observed relationship between ROA and financial distress emphasizes the importance of examining the productivity of corporate assets. When investments and operating assets fail to generate expected returns, profitability can weaken, particularly if resources are allocated inefficiently or operating costs are not controlled. Inefficient asset utilization can therefore contribute to financial pressure. A deterioration in ROA may also function as an early warning indicator when it occurs together with other unfavorable financial measures. Future research could investigate the operational causes of inefficient asset use in manufacturing firms and identify more specifically how asset productivity contributes to financial distress.

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