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The Effect of Financial Slack on Firm Performance with Lender's Monitoring as a Moderating Variable

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Abstract: This study investigates the effect of financial slack on corporate financial performance, by exploring the role of lender's monitoring as a moderating variable. Using a quantitative approach and moderated regression analysis, data were collected from 273 non-financial companies listed on the Indonesia Stock Exchange in 2023. The study offers a theoretical contribution by testing the validity of agency theory in an emerging market context such as Indonesia, as well as a practical contribution in evaluating the effectiveness of creditor oversight as a managerial control tool over financial slack. Empirical results show that financial slack has a significantly negative effect on financial performance (ROA), indicating potential managerial dysfunction due to excess liquidity. Meanwhile, lender's monitoring does not show a statistically significant moderating effect. This study highlights the limitations of external monitoring effectiveness in emerging markets and underscores the importance of adaptive and disciplined financial governance in managing slack resources.

Keywords: Financial Slack, Financial Performance, ROA, Lender's Monitoring.

INTRODUCTION

Fluctuating global and national economic conditions require firms to maintain financial flexibility to ensure sustainable performance. Companies are expected to be adaptive and remain relevant amid industry changes. They must continually innovate in both products and services by focusing on customer needs to gain competitive advantage and succeed in the market. Additionally, companies must be prepared to face economic uncertainties, both micro and macro, by maintaining reserve resources as buffers to deal with uncontrollable factors such as natural disasters or pandemics like COVID-19. In such a dynamic business environment, companies face various challenges in managing financial resources to achieve optimal performance.

One source of financial flexibility is financial slack, which refers to excess financial resources beyond routine operational needs. Financial slack is an essential element that can be used flexibly during crises. As highlighted by Liang, Wang, and Xu (2023), financial slack

enhances organizational resilience by providing reserves that enable strategic decision-making in response to fluctuating demand. During the COVID-19 pandemic, companies with larger cash reserves performed better in addressing supply chain disruptions and economic uncertainty (Gurbuz, Kecici, & Aybars, 2023). Financial slack is often linked to a firm's ability to adapt, innovate, and make strategic investments in uncertain environments (Zona, 2012; Deb et al., 2017; Guo et al., 2020; Uyar et al., 2023).

However, not all firms can utilize financial slack optimally. Financial slack serves a dual role—acting both as a buffer against risks and a potential source of agency conflict. From an agency theory perspective, unmanaged financial slack may lead to agency problems, where managers pursue personal interests misaligned with those of shareholders (Jensen & Meckling, 1976). Excess slack may also indicate inefficiencies that require evaluation. Liang et al. (2023) found that instead of attracting more investments, management with higher financial slack demonstrated poorer cost management. This was due to reduced internal control over financial resource usage. The issue becomes more complex when external monitoring mechanisms are insufficient (Siregar & Utama, 2008). Prior studies in the U.S. indicated a positive relationship between financial slack and firm performance, which was strengthened by high lender monitoring levels (Jermias & Yigit, 2022).

This study aims to examine financial slack in Indonesia, where its impact is context-dependent and influenced by organizational contingencies. Some studies show that the effectiveness of financial slack is not universally applicable, but rather contingent upon internal and external monitoring, industry characteristics, and corporate governance structures. As a developing country, Indonesia faces both global economic fluctuations and domestic political dynamics. Many firms struggle to manage slack due to limited financial access, varying lender oversight, and inconsistent corporate governance practices. Furthermore, the moderating role of lender monitoring remains underexplored in the Indonesian context. Thus, this research contributes to developing more effective financial strategies for firms. Local studies by Pasaribu and Haryanto (2018) and Kusumastuti et al. (2020) show that well-managed financial slack enhances performance in the manufacturing sector.

Therefore, this research has two objectives: (1) to examine whether financial slack significantly affects firm performance across all industries in Indonesia, and (2) to assess whether lender monitoring moderates the relationship between financial slack and firm performance. This study aims to enrich the literature by exploring this relationship in a multi-industry setting, offering insights relevant to Indonesia's current industrial landscape, and contributing to the development of effective financial strategies. It also serves as a reference for financial managers, investors, and creditors in efficiently managing financial resources to enhance firm performance

Agency theory serves as the foundational framework in this study to explain how financial slack is managed by corporate management and how lender's monitoring acts as a mechanism to align managerial and shareholder interests. Agency theory outlines the principal-agent relationship, where the principal delegates authority or tasks to an agent who executes them (Fama & Jensen, 1983). This relationship often leads to information asymmetry, wherein agents possess more comprehensive and in-depth knowledge about the firm than the principals (Myers & Majluf, 1984).

Jensen & Meckling (1976) argue that both principals and agents act to maximize their own interests, and thus, agents may not always act in the best interest of the principal. Principals typically try to reduce these conflicts by setting appropriate incentives and monitoring mechanisms. The costs incurred from these efforts are known as agency costs. These costs depend on (1) the personality of management team members, (2) their discretion in using resources to maximize shareholder wealth, (3) monitoring costs, and (4) bonding expenditures between stakeholders.

Key implications of agency theory in the relationship between financial slack and firm performance include: (1) the risk of losses due to investment in unprofitable projects (Kim et al., 2008; Zona, 2012), (2) diminished managerial control over financial resource allocation leading to inefficiencies (Liang et al., 2023), and (3) significant information asymmetry, which increases agency costs and financial risk.

The Relationship Between Financial Slack and Firm Performance

Several studies have highlighted the positive impact of financial slack, particularly its role as a precautionary measure against short-term losses and as a buffer for unexpected costs arising from future uncertainties (Fan et al., 2020). Financial slack also functions as a reserve of resources that enables firms to maneuver strategically, allowing them to adapt to external pressures resulting from environmental changes (Bradley et al., 2011). Research by Bradley et al. (2011), Kim et al. (2008), and Natividad (2013) further found that financial slack increases firms' opportunities to invest in research and development (R&D) activities. Indirectly, financial slack guides management toward implementing innovation strategies through a series of experimental, research, and development initiatives.

On the other hand, Kim et al. (2008), as cited by Zona (2012), argue that financial slack may lead management to pursue high-risk projects, driven by irrational optimism. Companies with financial slack may foster managerial complacency, excessive optimism, and a diminished sense of urgency to invest in R&D. Instead of allocating slack resources toward research and development, management may become more relaxed and inefficient. Supporting this view, Liang et al. (2023) found that under conditions of demand uncertainty, firms with high levels of financial slack tend to exhibit poorer cost management performance, rather than channeling these resources into innovation activities. This condition also raises the concern that financial slack might merely reflect managerial preferences for internal over external financing (e.g., debt), rather than serving a strategic purpose.

The Moderating Effect of Lender's Monitoring on the Relationship Between Financial Slack and Firm Performance

Jermias and Yigit (2022) found that lender's monitoring strengthens the positive relationship between financial slack and firm performance. Therefore, to sharpen the findings of this study, we examine the moderating role of lender's monitoring in the relationship between financial slack and firm performance. This is in line with Jensen (1993), who emphasized that without proper monitoring, managers tend to overinvest company funds in unprofitable projects. Dybvig and Zender (1991) proposed that lender's monitoring facilitates goal alignment between management and shareholders. Simerly and Li (2000) argued that creditor obligations can constrain managers from undertaking unprofitable and self-serving investments. Kim et al. (2011) found that lender's monitoring enhances internal control and improves financial disclosure. In the Indonesian context, research by Siregar and Utama (2008) indicated that external monitoring, including lender's monitoring, plays a significant role in mitigating the misuse of financial resources by management.

METHOD

The population of this study comprises all companies listed on the Indonesia Stock Exchange (IDX) that published financial statements for the 2023 fiscal year, totaling 880 firms. The researcher employed a purposive sampling method by applying specific criteria, resulting in a final research sample of 273 companies. The sample distribution by industry is presented in Table 1.1:

Table 1. Number of Companies Listed on the IDX in 2023 by Industry Sector

Industry	Number of Firm
Basic Materials	27
Consumer Cyclicals	37
Consumer Non-Cyclicals	67
Energy	27
Healthcare	10
Industrials	20
Infrastructures	35
Properties & Real Estate	26
Technology	5
Transportation & Logistic	19
Total	273

Source : TICMI

This study involves three types of variables: the dependent variable is financial slack (FS), the independent variable is firm performance (ROI), and the moderating variable is lender's monitoring (MR). The operational definitions of each variable are outlined in Table 1.2 below:

Table 2. Operastonal Variabel

No	Variable	Indicator	Formula	Scale
1	*Financial Slack* (Independent Variable/ X)	Selisih antara *Current Ratio* Perusahaan dengan *Average Current Ratio* Industri	*(Current Ratio* Perusahaan – *Average Current Ratio* Industri)/ *Average Current Ratio* Industri	Ratio
2	Firm Performance (Dependent Variable/ Y)	*Return on Asset*	*Net Income / Total Assets*	Ratio
3	*Lender's Monitoring (Moderating Variable / M)*	*Debt to Equity Ratio*	*Debt / Equity*	Ratio

Statistical analysis in this study was preceded by classical assumption testing, which includes the Normality Test, Multicollinearity Test, and Heteroscedasticity Test. Hypothesis testing was conducted using Moderated Regression Analysis (MRA) to examine the interaction effect of the moderating variable.

RESULTS AND DISCUSSION

In analyzing the data, classical assumption tests were conducted first, yielding the following results: (1) the data used in this study are normally distributed (using a significance level of 5%, the p-value obtained was 0.200 > 0.05); (2) there is no serious multicollinearity problem within the model, as the Variance Inflation Factor (VIF) values for all independent variables remain below 10 (Financial Slack: 1.544, Long Term Debt to Equity: 2.044, and Interaction: 2.025); and (3) overall, the model does not exhibit strong heteroscedasticity.

Based on the statistical analysis conducted, the coefficient for Financial Slack (X) is -0.015 with a significance value of 0.020, indicating that Financial Slack (X) and Long Term Debt to Equity (M) have a significant negative effect on Return on Investment (Y). Each one-unit increase in Financial Slack is associated with a decrease in ROI by 0.015 units, with a statistically significant effect ($p < 0.05$).

The statistical test results for Long Term Debt to Equity (M) show a coefficient of -0.110 with a significance value less than 0.001, indicating a significant negative effect on ROI. This

means that every one-unit increase in M decreases ROI by 0.110 units, with a statistically significant influence ($p < 0.05$).

Regarding the interaction term between Financial Slack and Long Term Debt to Equity (X×M), the coefficient is 0.030 with a significance value of 0.142. This positive coefficient suggests that Long Term Debt to Equity may moderate the relationship between Financial Slack and ROI. However, since the significance value is $p = 0.142 > 0.05$, the moderating effect is not statistically significant. Therefore, it can be concluded that Long Term Debt to Equity (M) does not have a significant moderating effect on the relationship between Financial Slack (X) and ROI (Y).

Tabel 3. Moderated Regression Test Result

Model		Unstandardized Coefficients	
		B	Std. Error
1	(Constant)	.294	.015
	SQRTX2	-.015	.006
	SQRTM2	-.110	.031
	SQRTX2_M2	.030	.020

a. Dependent Variable: SQRTY2

Based on the statistical analysis conducted, it was found that Financial Slack (X) and Long Term Debt to Equity (M) have a significant negative effect on Return on Investment (ROI) (Y). Additionally, Long Term Debt to Equity (M) does not have a significant moderating effect on the relationship between Financial Slack (X) and ROI (Y). These results can be explained as follows:

Negative Effect of Financial Slack and Long Term Debt to Equity on ROI

This study found that Financial Slack has a negative effect on ROI. This finding can be explained by Agency Theory, which posits that excess financial resources may encourage managers to use funds inefficiently (Jensen & Meckling, 1976). In other words, companies with excess cash tend to direct management toward pursuing high-risk projects, leading to irrational optimism or using slack to ease political coalitions rather than driving changes toward corporate improvement, ultimately resulting in decreased profitability (Kim et al., 2008; Zona, 2012; Wiersma, 2017).

The significant negative relationship between financial slack and firm performance aligns with the study by Picoloa et al. (2016) conducted on firms in Chile. Moreover, this study supports the findings of Liang et al. (2023), who discovered that management with greater financial slack exhibits poorer cost management performance. Financial slack causes managerial relaxation in managing financial resources, resulting in inefficient cost usage. Ideally, financial slack should serve as a strategic resource that enhances competitive advantage if utilized optimally. However, if a firm fails to allocate slack effectively, the excess funds may become a burden, reducing resource management efficiency and negatively impacting ROI.

This study's findings contrast with those of Jermias & Yigit (2022), where financial slack had a significant positive effect on financial performance. The geographic context differs, with the former study involving multi-sector companies in Indonesia and the latter focusing on S&P 500 companies in the United States. Such sample scope differences introduce varying environmental variables such as economic volatility, investment climate, financing policies, corporate culture, and accounting standards adoption.

Differences in results also occur within Indonesian companies but limited to the manufacturing industry, as in Pasaribu & Haryanto (2018). This indicates that the manufacturing sector, which typically requires substantial funds for innovation, production, and market expansion, benefits from financial slack. Industries characterized by high volatility and innovation investment needs (e.g., technology, consumer cyclicals) generally gain advantages from financial slack. Industries with significant capital requirements, high innovation demands, and market uncertainties are more likely to exhibit a positive relationship between financial slack and firm performance, especially when coupled with effective monitoring.

Insignificance of the Moderating Effect of Long Term Debt to Equity

The results indicate that Long Term Debt to Equity does not have a significant moderating effect on the relationship between Financial Slack and ROI. This means that the presence of long-term debt in a company's capital structure neither strengthens nor weakens the relationship between financial slack and ROI.

This can be explained by the limited role of debt in managing slack. Within the corporate context, financial slack is generally more influenced by managerial decisions in resource allocation than by external factors such as debt structure. Therefore, whether long-term debt is high or low does not directly alter the impact of financial slack on ROI. Furthermore, the primary objective of lender's monitoring is typically to ensure that the company meets its debt obligations (principal plus interest) on time. This monitoring is reactive and defensive rather than proactive in maximizing firm performance. In other words, creditors focus more on credit risk and short-to-medium-term liquidity rather than how the company utilizes financial slack to improve performance or long-term investments. They do not always closely monitor the effectiveness of financial slack usage, such as innovation investment, expansion, or efficiency management, which can affect ROI.

Another factor relates to Agency Theory, specifically information asymmetry between principals and agents, where management possesses more comprehensive information regarding operations and fund usage than creditors. Consequently, lender's monitoring faces difficulties controlling all aspects of financial slack usage. This information asymmetry widens due to creditors' limited resources and monitoring capacity. Creditors are not always capable of conducting detailed supervision beyond basic credit risk assessments.

CONCLUSION

In conslusion, this study confirms that excessive financial slack can be detrimental to a company's financial performance, thereby necessitating more disciplined and strategic management of liquidity surpluses. Although lender's monitoring was not found to play a significant moderating role in this relationship, firms should still consider other supervisory mechanisms, such as strengthening corporate governance and enhancing transparency in financial management, to mitigate the negative impacts of financial slack.

The practical implication of this research is that management must carefully maintain an optimal level of financial slack and ensure that any excess funds are productively utilized to improve the company's financial performance. Unutilized excess funds can adversely affect financial outcomes. Management needs to guarantee that available financial slack is used efficiently, either for value-adding investments or as a strategically managed reserve governed by clear policies. Additionally, companies may implement stricter governance mechanisms to reduce the potential for fund misappropriation by managers, which can harm shareholders.

For creditors or lenders, although this study indicates that lender's monitoring does not significantly moderate the relationship between financial slack and financial performance, there remains a need for more effective oversight strategies. Lenders can enhance transparency

within their monitoring systems by adjusting supervisory mechanisms related to the firm's fund utilization, for instance, through more detailed financial reporting requirements or periodic evaluations of financial resource allocation. Such measures can help minimize the risk of fund misallocation, which may reduce the company's long-term profitability.

For academics and future researchers, these findings may serve as a reference for further studies considering additional factors that influence the relationship between financial slack and financial performance, such as ownership structure, investment policies, and macroeconomic or industry conditions. Moreover, future research could employ more diverse methodologies, including qualitative analyses, to gain deeper insights into the role of lender's monitoring in corporate financial dynamics. With more comprehensive follow-up studies, more effective strategies to manage financial slack can be identified to support sustainable business growth.

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