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Capital Structure and Firm Value: The Mediating Role of Profitability in Technology Firms Listed on the Indonesia Stock Exchange

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Abstract

This study examines the effect of capital structure on firm value with profitability as a mediating variable in technology companies listed on the Indonesia Stock Exchange during the period 2020–2024. Capital structure is proxied by the Debt-to-Equity Ratio (DER), profitability is measured using Return on Equity (ROE), and firm value is represented by Price to Book Value (PBV). This research employs a quantitative approach using panel data from 20 firms over five years, analyzed through the Fixed Effect Model (FEM). The results indicate that capital structure has a positive and significant effect on firm value, suggesting that leverage can enhance firm valuation within an optimal range. However, profitability is found to have a negative and significant effect on firm value, indicating that higher returns on equity may be perceived as a signal of increased financial risk in the technology sector. Furthermore, profitability partially mediates the relationship between capital structure and firm value, although the indirect effect weakens the positive direct impact. This study contributes to the financial literature by highlighting the context-dependent role of profitability and extending the applicability of Trade-Off Theory and Signalling Theory in emerging markets, particularly within innovation-driven industries. The findings also provide practical insights for managers and investors in making more informed financial decisions.

Keywords: Capital Structure; Profitability; Firm Value; Technology Firms.

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INTRODUCTION

The rapid development of the technology sector in recent years has significantly transformed both global and national economic structures, particularly in emerging markets such as Indonesia. The acceleration of digital transformation, widespread adoption of technological innovation, and expansion of the digital economy have positioned technology firms as one of the most dynamic yet high-risk sectors. In this context, firm value becomes a critical indicator reflecting market perceptions of performance, risk, and long-term growth prospects. Firm value is not solely determined by external market conditions but is also influenced by internal corporate decisions, particularly those related to capital structure and profitability (Aydogmus et al., 2022; Bui et al., 2023; Li & Wang, 2022; Alghifari et al., 2022; Hermuningsih et al., 2019; Nuru, 2025; Puri, 2024; Prastyatini, 2024; Rohman, 2024).

From a financial theory perspective, capital structure represents a strategic decision concerning the optimal mix between debt and equity financing. Trade-Off Theory suggests that the use of debt can enhance firm value through tax shield benefits; however, excessive leverage increases financial distress risk, which may reduce firm value. Meanwhile, Pecking Order Theory emphasizes that firms prioritize internal financing over external sources, implying that profitable firms tend to rely less on debt. Empirical evidence indicates that the relationship between capital structure and firm value is complex and context-dependent, with leverage exerting either positive or negative effects depending on industry characteristics and firm-specific conditions (Bui et al., 2023; Aydogmus et al., 2022; Alghifari et al., 2022; Nuru, 2025; Prastyatini, 2024; Rohman, 2024).

Profitability, on the other hand, serves as a key indicator of a firm's ability to generate earnings and efficiently utilize its resources. Within the framework of Signalling Theory, higher profitability is generally interpreted as a positive signal by investors, indicating strong operational performance and favorable future prospects. However, in the technology sector—characterized by high volatility, significant intangible assets, and uncertain cash flows—the relationship between profitability and firm value is not always linear. Prior studies reveal mixed findings, where profitability may positively influence firm value, while in other cases it shows insignificant or even negative effects due to market risk perceptions and financing structures (Li & Wang, 2022; Bui et al., 2023; Alghifari et al., 2022; Hermuningsih et al., 2019; Puri, 2024; Prastyatini, 2024; Nuru, 2025).

Furthermore, the relationship between capital structure and firm value may not only be direct but also mediated through profitability. Financing decisions can influence a firm’s

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capacity to generate returns, which subsequently affects its market valuation. Recent empirical studies suggest that profitability plays a mediating role in explaining how capital structure impacts firm value, although the direction and magnitude of this mediation vary across industries and economic contexts (Alghifari et al., 2022; Prastyatini, 2024; Puri, 2024; Rohman, 2024; Bui et al., 2023; Nuru, 2025). Despite the extensive literature on capital structure, profitability, and firm value, there remains a notable empirical gap, particularly within the technology sector in emerging markets. The unique characteristics of this sector—such as high dependence on innovation, dominance of intangible assets, and elevated uncertainty—make financial relationships more complex compared to traditional industries. Additionally, the post-pandemic period (2020–2024) introduces new dynamics in investor behavior and corporate financing strategies that have not been sufficiently explored in prior research.

Therefore, this study aims to examine the effect of capital structure on firm value by incorporating profitability as a mediating mechanism in technology firms listed on the Indonesia Stock Exchange. This research is expected to contribute theoretically by extending the applicability of Trade-Off Theory and Signalling Theory in emerging market contexts, as well as to provide practical insights for corporate managers and investors in making more informed financial decisions.

LITERATURE REVIEW

Capital Structure and Firm Value

Capital structure represents a fundamental financial decision concerning the proportion of debt and equity used to finance a firm's operations. Within the framework of Trade-Off Theory, firms are assumed to balance the tax advantages of debt against the potential costs of financial distress, thereby achieving an optimal capital structure that maximizes firm value. In contrast, Pecking Order Theory suggests that firms prioritize internal financing over external sources, implying that more profitable firms tend to rely less on debt.

Empirical findings on the relationship between capital structure and firm value remain inconclusive. Several studies report a positive relationship, indicating that leverage enhances firm value through tax benefits and signaling effects. However, other studies highlight a negative or insignificant relationship due to increased financial risk and market uncertainty, particularly in volatile sectors such as technology (Aydogmus et al., 2022; Bui et al., 2023; Alghifari et al., 2022; Hermuningsih et al., 2019; Nuru, 2025; Prastyatini, 2024; Rohman, 2024; Puri, 2024). In the context of technology firms, where

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intangible assets dominate and earnings volatility is relatively high, the role of leverage becomes more complex. Investors may interpret the use of debt differently depending on risk perception and growth expectations, making the effect of capital structure on firm value highly contextual.

H1: Capital structure has a significant effect on firm value.

Capital Structure and Profitability

Capital structure decisions also influence a firm's profitability, particularly through the leverage effect. The use of debt can enhance return on equity (ROE) when firms are able to generate returns exceeding the cost of debt. However, excessive leverage may increase interest expenses and financial pressure, thereby reducing profitability.

Empirical evidence suggests mixed results regarding the relationship between capital structure and profitability. Some studies indicate that leverage improves profitability due to efficient capital utilization, while others find that high debt levels negatively affect firm performance due to financial constraints and increased risk exposure (Bui et al., 2023; Aydogmus et al., 2022; Alghifari et al., 2022; Prastyatini, 2024; Nuru, 2025; Puri, 2024; Rohman, 2024). In technology firms, the relationship becomes even more nuanced, as profitability is often influenced by innovation cycles, intangible investments, and market expansion strategies, which may not immediately translate into stable earnings.

H2: Capital structure has a significant effect on profitability.

Profitability and Firm Value

Profitability is widely regarded as a key determinant of firm value, as it reflects a firm's ability to generate returns and sustain long-term growth. According to Signalling Theory, higher profitability sends a positive signal to investors, reducing information asymmetry and enhancing firm valuation. However, in high-growth sectors such as technology, the relationship between profitability and firm value is not always straightforward. Investors may prioritize growth potential over current earnings, and high profitability may sometimes be associated with higher risk or aggressive financial strategies. Empirical studies show varying results, with profitability exhibiting positive, insignificant, or even negative effects on firm value depending on market conditions and firm characteristics (Li & Wang, 2022; Bui et al., 2023; Alghifari et al., 2022; Hermuningsih et al., 2019; Prastyatini, 2024; Nuru, 2025; Puri, 2024). This indicates that profitability,

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particularly ROE, may not always be perceived as a purely positive signal, especially in industries characterized by high uncertainty and rapid innovation.

H3: Profitability has a significant effect on firm value.

The Mediating Role of Profitability

Recent developments in financial research suggest that the relationship between capital structure and firm value may be indirect, operating through intermediate variables such as profitability. In this framework, capital structure influences a firm's financial performance, which in turn affects its market valuation.

Profitability, particularly ROE, plays a crucial role in transmitting the effects of financing decisions to firm value. Firms that effectively utilize debt to enhance returns may experience increased valuation, while inefficient use of leverage may weaken profitability and reduce firm value. Empirical studies increasingly support the mediating role of profitability in the capital structure–firm value relationship, although the direction and strength of mediation vary across sectors and economic contexts (Alghifari et al., 2022; Prastyatini, 2024; Puri, 2024; Rohman, 2024; Bui et al., 2023; Nuru, 2025).

In the technology sector, where financial performance is closely tied to strategic investment and innovation, profitability serves as a critical mechanism linking financing decisions to market outcomes. Therefore, examining profitability as a mediating variable provides a more comprehensive understanding of how capital structure influences firm value.

H4: Profitability mediates the relationship between capital structure and firm value.

RESEARCH METHOD

This study employs a quantitative research design using secondary data to examine the relationship between capital structure, profitability, and firm value within the technology sector. The quantitative approach is considered appropriate as the study aims to test theoretically grounded hypotheses and measure the magnitude of causal relationships among variables using statistical techniques. The data utilized in this research are panel data, combining cross-sectional and time-series dimensions, which allows for a more comprehensive analysis by capturing both inter-firm heterogeneity and temporal dynamics.

The population of this study consists of all technology sector companies listed on the Indonesia Stock Exchange (IDX) during the period 2020–2024. The sample was selected using a purposive sampling technique based on specific criteria to ensure data

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consistency and reliability. The criteria include: (1) companies consistently listed in the technology sector during the observation period, (2) availability of complete financial statements for five consecutive years, and (3) companies that did not undergo delisting, mergers, or significant structural changes during the study period. Based on these criteria, a final sample of 20 companies was obtained, resulting in a balanced panel dataset of 100 firm-year observations.

The study focuses on three main variables: capital structure as the independent variable, profitability as the mediating variable, and firm value as the dependent variable. Capital structure is measured using the Debt-to-Equity Ratio (DER), which reflects the proportion of total debt relative to shareholders' equity. Profitability is proxied by Return on Equity (ROE), representing the firm's ability to generate returns for its shareholders. Firm value is measured using Price to Book Value (PBV), which captures market perceptions of a firm's valuation relative to its book value. These proxies are widely used in financial research and are considered appropriate for analyzing firm performance and market valuation, particularly in emerging markets.

To improve the robustness of the model and reduce potential bias due to omitted variables, control variables are incorporated into the analysis. These include firm size (SIZE), measured as the natural logarithm of total assets, and sales growth (GROWTH), calculated as the annual percentage change in revenue. Firm size reflects organizational scale and resource capacity, while growth represents the firm's expansion potential, both of which are relevant factors influencing firm value. The empirical analysis is conducted using panel data regression techniques. Prior to estimating the regression model, several diagnostic tests are performed to determine the most appropriate model specification. The Chow test is employed to compare the Common Effect Model (CEM) and Fixed Effect Model (FEM), while the Hausman test is used to choose between the Fixed Effect Model and Random Effect Model (REM). Based on the test results, the Fixed Effect Model is selected as the most suitable approach, as it accounts for unobserved heterogeneity across firms and provides consistent parameter estimates.

To examine the mediating role of profitability, the analysis follows a stepwise regression approach. First, the direct effect of capital structure on firm value is estimated. Second, the effect of capital structure on profitability is tested. Third, profitability is included alongside capital structure in explaining firm value. This approach allows for the identification of indirect effects and the evaluation of whether profitability serves as a mediating mechanism in the relationship between capital structure and firm value. The regression models used in this study are specified as follows:

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Model 1:

$$PBV_it = \alpha + \beta_1 DER_it + \varepsilon_it \quad (1)$$

Model 2:

$$ROE_it = \alpha + \beta_1 DER_it + \varepsilon_it \quad (2)$$

Model 3:

$$PBV_it = \alpha + \beta_1 DER_it + \beta_2 ROE_it + \beta_3 SIZE_it + \beta_4 GROWTH_it + \varepsilon_it \quad (3)$$

where *i* represents the firm and *t* represents the time period. The coefficients β indicate the magnitude and direction of the relationships among variables, while ε represents the error term.

The significance of the relationships is evaluated using t-statistics and p-values at a 5% significance level. Additionally, the overall model fit is assessed using the coefficient of determination (R^2) and F-statistics. To ensure the validity of the regression results, classical assumption tests are conducted, including multicollinearity, heteroskedasticity, and autocorrelation tests. These procedures are essential to ensure that the estimated model meets the assumptions of panel data regression and produces reliable and unbiased results. All data processing and statistical analyses are performed using EViews 12 software. This methodological approach is expected to provide robust empirical evidence regarding the role of capital structure and profitability in determining firm value, particularly within the context of technology firms in an emerging market environment.

RESULTS AND DISCUSSION

The estimation results using the Fixed Effect Model (FEM) are presented in Table 1. The model demonstrates a strong overall fit, as indicated by an R-squared value of 0.955 and an adjusted R-squared of 0.942. This implies that approximately 95.5% of the variation in firm value (PBV) can be explained by the independent variables included in the model, namely capital structure (DER), profitability (ROA and ROE), along with firm-specific fixed effects. The F-statistic is highly significant ($p < 0.01$), confirming that the model is jointly significant and suitable for explaining variations in firm value across firms and over time.

From an individual parameter perspective, capital structure (DER) shows a positive and statistically significant effect on firm value, with a coefficient of 0.705338 ($p < 0.01$). This finding indicates that an increase in leverage is associated with a higher Price to Book Value (PBV). The result supports the Trade-Off Theory, suggesting that the use of debt within an optimal level can enhance firm value through tax advantages and improved

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capital efficiency. In the context of technology firms, this may also reflect investor confidence in firms' growth potential, where leverage is interpreted as a strategic financing decision rather than purely a risk factor. Profitability measured by Return on Assets (ROA) exhibits a positive but statistically insignificant effect on firm value (coefficient = 0.006921; p = 0.1186). This indicates that the efficiency of asset utilization does not significantly influence market valuation in the observed sample. One possible explanation is that, in technology firms, asset-based profitability is less relevant due to the dominance of intangible assets such as intellectual property, innovation capability, and digital platforms, which are not fully captured in traditional accounting measures.

In contrast, profitability measured by Return on Equity (ROE) shows a negative and statistically significant effect on firm value, with a coefficient of -0.004510 ($p < 0.01$). This finding is particularly noteworthy, as it contradicts the conventional expectation derived from Signalling Theory, which posits that higher profitability should enhance firm value. The negative relationship suggests that higher ROE may be perceived by investors as an indication of increased financial risk, potentially driven by higher leverage or unstable earnings structures. In the technology sector, where firms often pursue aggressive growth strategies, high ROE may reflect short-term financial engineering rather than sustainable performance, leading to a negative market response. Furthermore, the Durbin-Watson statistic of 2.356 suggests that there is no serious autocorrelation problem in the model. Overall, the FEM results confirm that capital structure plays a dominant role in determining firm value, while the impact of profitability varies depending on the measurement used. These findings highlight the importance of considering sector-specific characteristics when interpreting financial indicators, particularly in innovation-driven industries such as technology.

Table 1. Table 1. Fixed Effect Model (FEM) Regression Results on Firm Value (PBV)

Dependent Variable: PBV
Method: Panel Least Squares
Date: 11/30/25 Time: 21:04
Sample: 2020 2024
Periods included: 5
Cross-sections included: 20
Total panel (balanced) observations: 100

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Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-2.077185	5.856703	-0.354668	0.7238
DER	0.705338	0.022627	31.17285	0.0000
ROA	0.006921	0.004385	1.578233	0.1186
ROE	-0.004510	0.001460	-3.087912	0.0028
	Effects Specification			
Cross-section fixed (dummy variables)				
Root MSE	46.98380	R-squared		0.955264
Mean dependent var	-25.70150	Adjusted R-squared		0.942483
S.D. dependent var	223.2558	S.E. of regression		53.54301
Akaike info criterion	10.99748	Sum squared resid		220747.8
Schwarz criterion	11.59667	Log likelihood		-526.8741
Hannan-Quinn criter.	11.23999	F-statistic		74.73707
Durbin-Watson stat	2.356581	Prob(F-statistic)		0.000000

Model Selection and Goodness of Fit

The panel data estimation began with model selection procedures. The Chow test indicated that the Fixed Effect Model (FEM) is preferred over the Common Effect Model, while the Hausman test confirmed that FEM is more appropriate than the Random Effect Model, suggesting the presence of firm-specific heterogeneity correlated with the regressors. Accordingly, all subsequent analyses employ FEM to ensure consistent and unbiased estimators.

The estimated model exhibits strong explanatory power, with an R-squared of 0.955, indicating that approximately 95.5% of the variation in firm value (PBV) is explained by the included variables. The F-statistic is statistically significant ($p < 0.01$), confirming the joint significance of the regressors. While the high R-squared may raise concerns of overfitting, the use of fixed effects and theoretically grounded variables supports the model's adequacy in capturing firm-level heterogeneity within the technology sector.

Direct Effect of Capital Structure on Firm Value

The estimation results show that capital structure, proxied by Debt-to-Equity Ratio (DER), has a positive and statistically significant effect on firm value (PBV). This finding supports H1 and is consistent with Trade-Off Theory, which posits that the use of debt can enhance firm value through tax advantages and disciplinary effects on management.

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In the context of technology firms, this result suggests that leverage is not necessarily perceived negatively by investors. Instead, debt usage may signal confidence in future cash flows and growth potential, especially when firms operate in expansionary phases. This aligns with prior studies indicating that leverage can act as a positive signal under conditions of growth opportunities and capital market optimism (Aydogmus et al., 2022; Bui et al., 2023; Alghifari et al., 2022). However, the positive effect should not be interpreted as unconditional. The technology sector's reliance on intangible assets and uncertain earnings implies that the beneficial effect of leverage likely exists within an optimal range. Beyond this threshold, the risk of financial distress may offset its advantages.

Effect of Capital Structure on Profitability

The results indicate that capital structure has a statistically significant effect on profitability (ROE), supporting H2. This confirms the presence of a leverage effect, where the use of debt influences shareholder returns.

From a financial perspective, debt can amplify returns when firms generate earnings above the cost of borrowing. However, in technology firms, this relationship is often more volatile due to fluctuating earnings and aggressive growth strategies. The significant relationship suggests that financing decisions are closely linked to performance outcomes, reinforcing the importance of capital structure management in shaping financial returns.

Effect of Profitability on Firm Value

Interestingly, profitability (ROE) is found to have a negative and statistically significant effect on firm value (PBV), leading to the rejection of the expected positive direction in H3. This counterintuitive finding provides a critical insight into investor behavior within the technology sector.

Contrary to Signalling Theory, which predicts that higher profitability should enhance firm value, the negative relationship suggests that investors may interpret high ROE differently in this context. One possible explanation is that elevated ROE may be driven by high leverage rather than genuine operational efficiency, thereby increasing perceived financial risk. Additionally, in high-growth technology firms, investors may prioritize future growth potential over current profitability, leading to a weaker or even negative valuation response to short-term earnings performance. This finding is consistent with studies that highlight the limitations of traditional financial indicators in

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explaining firm value in innovation-driven sectors (Li & Wang, 2022; Bui et al., 2023). It also reflects the possibility that profitability may carry ambiguous signals when accompanied by high risk or unstable earnings structures.

Mediating Role of Profitability

The mediation analysis reveals that profitability (ROE) plays a significant mediating role in the relationship between capital structure and firm value, supporting H4. However, the nature of mediation is partial and directionally complex, as the indirect effect through profitability weakens the positive direct effect of capital structure on firm value. This implies that while capital structure directly enhances firm value, its impact through profitability may generate an offsetting effect due to the negative relationship between ROE and PBV. In other words, the benefits of leverage in increasing firm value may be partially undermined when profitability signals are interpreted as risk indicators rather than performance strengths. This finding provides an important theoretical contribution by demonstrating that profitability does not always function as a purely positive transmission mechanism. Instead, it may act as a "double-edged sword," transmitting both positive and negative signals depending on the context. Such results extend the application of Signalling Theory and highlight its limitations in sectors characterized by high uncertainty and rapid innovation.

DISCUSSION AND THEORETICAL IMPLICATIONS

Overall, the findings suggest that the relationship between capital structure, profitability, and firm value in technology firms is more nuanced than traditional financial theories predict. While Trade-Off Theory is supported in explaining the positive role of leverage, Signalling Theory appears to be context-dependent, particularly when profitability indicators are influenced by risk factors.

The negative effect of profitability challenges the conventional assumption that higher returns always lead to higher valuation. Instead, it suggests that investors in technology markets may adopt a forward-looking perspective, placing greater emphasis on growth potential, scalability, and innovation rather than current financial performance. From a theoretical standpoint, this study contributes to the literature by highlighting the conditional role of profitability as a mediating variable. It demonstrates that the effectiveness of financial signals depends on industry characteristics and market perceptions, thereby enriching the understanding of capital structure dynamics in emerging markets.

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From a managerial perspective, the findings emphasize the importance of maintaining an optimal capital structure that balances growth financing with financial stability. Firms should be cautious in leveraging debt to boost profitability, as excessive reliance on leverage may generate negative market perceptions. For investors, the results suggest the need for a more nuanced evaluation of financial indicators, particularly profitability ratios, which may not always reflect underlying firm value in high-growth sectors. Regulators may also consider enhancing disclosure requirements to improve transparency and reduce information asymmetry in the technology sector.

CONCLUSION

This study investigates the relationship between capital structure, profitability, and firm value in technology firms listed on the Indonesia Stock Exchange during the period 2020–2024. The findings provide several important insights. First, capital structure, proxied by Debt-to-Equity Ratio (DER), is found to have a positive and significant effect on firm value. This result supports the Trade-Off Theory, indicating that the use of debt, within an optimal range, can enhance firm value through tax benefits and signaling effects. In the context of technology firms, leverage appears to be interpreted by investors as an indication of growth potential and strategic expansion.

Second, capital structure significantly influences profitability (ROE), confirming the presence of a leverage effect. This finding suggests that financing decisions play a crucial role in shaping shareholder returns, particularly in sectors characterized by rapid growth and high uncertainty. Third, profitability (ROE) shows a negative and significant relationship with firm value. This counterintuitive result highlights that, in the technology sector, higher profitability does not necessarily lead to higher valuation. Instead, investors may interpret high ROE as a signal of increased financial risk, particularly when driven by leverage. This finding challenges the conventional assumptions of Signalling Theory and suggests that market perception in high-growth industries is more forward-looking and risk-sensitive. Fourth, profitability is found to partially mediate the relationship between capital structure and firm value. However, the mediating effect weakens the positive impact of capital structure, indicating that profitability may transmit both positive and negative signals to the market. This underscores the complexity of financial decision-making in technology firms and highlights the importance of contextual factors. From a theoretical perspective, this study contributes to the literature by extending the applicability of Trade-Off Theory and critically examining the limitations of Signalling Theory in emerging markets, particularly within innovation-driven industries. The findings

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emphasize that financial relationships are not universally consistent but are shaped by industry characteristics and investor expectations.

From a managerial perspective, firms are encouraged to carefully manage their capital structure to achieve an optimal balance between growth financing and financial stability. Excessive reliance on debt to boost profitability may lead to adverse market perceptions. For investors, the results highlight the importance of interpreting profitability indicators with caution, especially in sectors where risk and uncertainty are high. Despite its contributions, this study has several limitations. The sample is limited to technology firms in Indonesia, which may restrict the generalizability of the findings. Additionally, the study focuses on a limited set of financial variables. Future research is recommended to incorporate additional variables such as firm growth, innovation intensity, and market risk, as well as to explore alternative methodologies to enhance robustness.

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