

The Effect of Leverage and Profitability on Stock Price with Firm Value as An Intervening Variable

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Article History: Received January 3, 2025; Received in revised from January 6, 2025; Accepted January 28, 2025; Published; February 7, 2025
How to Cite this Article: Susanti, D., Inayati, T., & Indahwati, I. (2025). The Effect of Leverage and Profitability on Stock Price with Firm Value as An Intervening Variable. <i>Turath</i> , 1(2), 105–119. https://doi.org/10.15642/turath.2024.1.2.105-119

Abstract: This study aims to investigate the effect of leverage and profitability on stock prices with firm value as an intervening variable in manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the period 2019–2023. A purposive sampling technique was used to select 227 firm-year observations based on specified criteria. The analysis was conducted using path analysis with SmartPLS 4 software. The findings indicate that leverage has no significant effect on firm value, while profitability positively affects firm value. Leverage negatively influences stock prices, whereas profitability does not have a direct impact. Additionally, firm value has a significant positive effect on stock prices. Furthermore, firm value does not mediate the relationship between leverage and stock price, but it does mediate the effect of profitability on stock price. These findings contribute to a deeper understanding of the dynamics between financial performance indicators and stock valuation, offering valuable insights for investors, financial analysts, and corporate managers in making more informed strategic and investment decisions.

Keywords: Leverage; Profitability; Stock Price; Firm Value

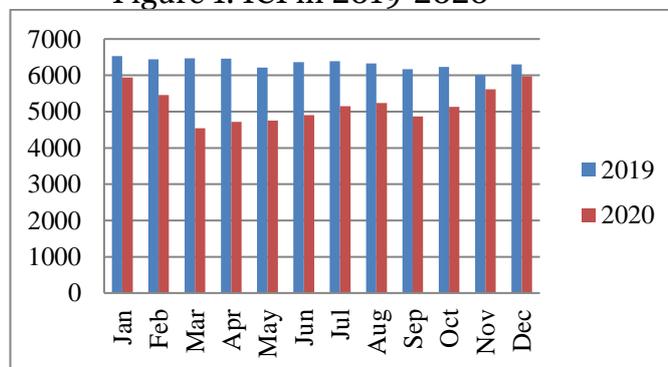
Introduction

The capital market plays a major role in a country's economy because it performs two functions at once. The capital market provides facilities to move funds from investors to issuing companies. Investors expect to get a return from the transfer of funds by investing the excess funds they have. Currently, the rapid development of the Indonesia Stock Exchange cannot be separated from the role of investors who make transactions on the Indonesia Stock Exchange. Before choosing to invest their money in the capital market, investors must complete a number of important tasks, including the evaluation of issuers (by purchasing securities listed on the exchange). Investors must have confidence that the information they provide is accurate.

Before deciding to invest their money, investors must undertake several important tasks, including evaluating issuers and securities listed on the exchange. This evaluation process is crucial to ensure that the information available is accurate and reliable, as investment decisions based on incorrect information can lead to losses. Therefore, investors need to conduct thorough analysis to make wise decisions and minimize risks. In 2019, the world faced the COVID-19 pandemic, which caused significant changes in various aspects of life, including the capital markets. The impact of this pandemic was substantial, affecting global economic activity and stock markets in various countries. This change necessitates adjustments in investment strategies and more careful risk management by investors. In the face of this uncertainty, it is important for investors to manage their portfolios wisely and consider factors that can affect the value of their investments. Careful evaluation of issuers, as well as monitoring stock price fluctuations, is key to making informed investment decisions.

Stock price movements tend to change all the time, which is a problem for investors because if the stock price drops, investors will suffer losses. Stock prices are very important for investors because stocks are one of the most promising investments. Stock price fluctuations are caused by the dynamics of demand and supply for these shares. In 2019 every, country is facing a COVID case that has caused significant changes to the entire order of life, especially in the economic sector. Based on BPS data on the investment sector, the 2019-2020 average movement of the ICI (Indonesia Composite Index) is shown in the figure below:

Figure 1. ICI in 2019-2020



Source: www.bps.go.id

The decline in the ICI (Indonesia Composite Index) from 2019 to 2020 was caused by a decline in stock prices in all sectors, which are divided into three classifications with their respective sub-classifications as follows: The raw material income sub-classification includes agriculture and mining; the manufacturing sub-classification consists of miscellaneous industries, basic and chemical industries, and the consumer goods industry; and the services sub-classification includes property and real estate, infrastructure, utilities, and transportation. A significant decline in share prices from 2019 to 2020 occurred in the manufacturing sector, reaching 38%, compared to raw material earnings which fell 36% and services which fell 26%. By the end of 2020, the manufacturing sector was only able to increase by 10% (Anggraeny & Suryana, 2022). In this context, the manufacturing sector experienced the most severe impact compared to other sectors. Data shows that the manufacturing sector faced a sharper decline than the raw materials and services sectors. The significant drop in stock prices in the manufacturing sector may indicate structural problems or market uncertainties affecting the sector, posing broader challenges in the stock market.

The share price is an indicator of the success of company management; when the share price increases, investors or potential investors view the company as having effectively managed its business. In addition, firm value is an important concept for investors, as it provides a comprehensive assessment of a company's overall market value. According to Nurlela & Ishaluddin (2008), firm value is the price that prospective buyers are willing to pay if the company were to be sold. This firm value can be influenced by various financial performance metrics such as leverage and profitability. Leverage, which refers to the use of debt in a company's capital structure, can have a dual impact on firm value enhancing profit potential through operational leverage while also increasing financial risks that may diminish investor confidence and firm value if not managed properly. On the other hand, a firm's profitability reflects its ability to generate consistent earnings, directly impacting firm value by signaling future earnings potential. Moreover, effective management of leverage and profitability can significantly influence stock prices, as investors closely monitor these indicators to gauge the company's financial health and growth prospects. Therefore, understanding the interplay between leverage, profitability, and firm value is crucial for investors and stakeholders in assessing the overall performance and stability of a company in the stock market.

Research Method

Signaling Theory, introduced by Michael Spence and Joseph Stiglitz in 1973, explains how firms convey signals to investors regarding their internal conditions and future prospects. In the context of leverage and profitability, the signals provided by a company can influence market reactions to its stock price. High leverage is often seen as a positive signal if interpreted as management's confidence in the firm's future prospects. For example, if a company announces an expansion plan funded by debt, this may be perceived as a sign of strong growth potential. If the market views this signal positively, the stock price is likely to rise. Conversely, excessive leverage that is perceived

as leading to high financial risk can result in negative signals, reducing investor interest and causing the stock price to fall. On the other hand, high profitability generally signals that a company can generate adequate earnings, enhancing its investment appeal and supporting an increase in stock price. Firm value acts as an intervening variable here, as the signals issued by the company regarding its financial health and future prospects affect firm value, which in turn impacts the stock price.

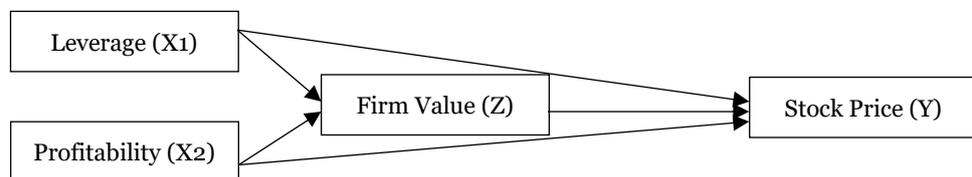
Trade-Off Theory, as outlined by Myers and Majluf (1984), focuses on the balance between the tax benefits of debt and the costs of financial distress. According to this theory, firms will use debt up to the point where the tax shields from additional debt are balanced by the potential costs of financial distress. Using debt can reduce tax burdens and increase firm value, but excessive debt can heighten financial risk, potentially harming firm value and stock price. In this context, firm value serves as a mediator between leverage decisions and stock price. When a company selects an optimal capital structure that leverages debt to capitalize on tax benefits without significantly increasing bankruptcy risk, firm value will rise. This increase in firm value, in turn, will enhance the stock price, highlighting the role of firm value as a mediator in this relationship.

Pecking Order Theory, also developed by Myers and Majluf in 1984, suggests that firms prefer to use internal funds (such as retained earnings) before seeking external financing. If internal funds are insufficient, firms will opt for debt, and only as a last resort will they consider issuing new equity. This theory indicates that firms with high profitability prefer to use retained earnings for financing, which can maintain or even increase stock value. Conversely, firms with lower profitability may be forced to rely on debt or equity, potentially decreasing stock value. Firm value plays a crucial role here, as capital structure decisions—based on Pecking Order Theory—affect firm value, which subsequently influences stock price. When a company adheres to this preference order, firm value increases, and the stock price reflects a healthy financial condition and positive growth potential. Overall, the integration of these theories illustrates that the impact of leverage and profitability on stock price is not only direct but also mediated by firm value. Firm value acts as a mediator that links corporate financing decisions—whether through debt or retained earnings—with the final outcome observed by the market, namely the stock price. In other words, decisions regarding capital structure and profitability affect firm value, which in turn influences market responses and stock price.

The type of research in this study is quantitative using the presentation of numerical data that reflects the relationship of each variable. Sugiyono (2017:81) quantitative research aims to identify relationships between variables, test theories, and seek generalizations that have predictive value. The data used in this study are secondary data of financial statements from the official website www.idx.co.id. The research population uses manufacturing companies on the Indonesia Stock Exchange (IDX). Sampling through purposive sampling technique. The sample used amounted to 227 based on the criteria determined as follows: (1) Manufacturing companies listed on the Indonesia Stock Exchange in 2019-2023, (2) Companies publish

and publish financial reports in the study period (3) Companies that do not experience consecutive losses. In this study, the documentation technique was used. The required document data is taken from pre-existing reports, such as financial statements and annual reports. These reports provide information related to assets, debt, capital, profit, number of shares outstanding, and stock price. This information greatly supports the research. Thus, the documentation technique is an effective method to collect relevant and accurate data. In conducting data testing using SmartPLS 4 software. The techniques used are outer model evaluation to test validity and reliability, inner model evaluation using the coefficient of determination to assess the strength of the relationship between variables. After that, it can be continued with intervening tests using path analysis to understand the direct and indirect relationships between variables. The following is a picture of the path model of this study:

Figure 2. Path analysis model of research variables



Leverage

Harahap (2013:86) Leverage is the ratio between corporate debt to capital, seeing how far the company is financed by debt or outside parties with the company's ability described by capital. In this study using the debt equity ratio formula:

$$\text{Debt To Equity Ratio (DER)} = (\text{Total Debt}) / (\text{Total Equity}) \times 100$$

Profitability

Sutrisno (2009:16) Profitability is the company's ability to generate profits using all available capital. In this study using the return on equity formula is as follows:

$$\text{Return On Equity (ROE)} = (\text{Earning After Tax}) / (\text{Total Equity}) \times 100$$

Firm Value

Firm value describes the state of the company and reflects the company's performance which affects investors' views on the company Hendrani & Septyanto (2021). In this study using the Tobin's Q formula is as follows:

$$\text{Tobin's Q} = (\text{Market value of the number of shares outstanding obtained from the number of shares outstanding} \times \text{closing} + \text{Total debt}) / \text{Total assets}$$

Stock Price

The price of a stock occurs in the stock exchange market which is determined by the demand and supply by market participants (Hartono, 2011). In this study using the stock price as follows:

$$\text{Stock Price} = \text{Closing Stock Price}$$

Results

Table 1. Construct Reliability and Validity

Variable	Cronbach's Alpha	Composite Reliability	AVE
Firm Value	1.000	1.000	1.000
Leverage	1.000	1.000	1.000
Profitability	1.000	1.000	1.000
Stock Price	1.000	1.000	1.000

Source: Output SmartPLS (2024)

Based on table 1. Shows the Average Variance Extracted (AVE) value on the firm value, leverage, profitability, and stock price variables is more than 0.50, so it meets good or valid convergent validity. The Cronbach's Alpha value of each research variable > 0.7 and the Composite reliability value > 0.6, so the research has met the requirements of consistent variable data, so it can be said that all constructs have a good level of reliability.

Table 2. Coefficient of Determination

Variable	R Square	R Square Adjusted
Firm Value	0.552	0.548
Stock Price	0.545	0.539

Source: Output SmartPLS (2024)

Based on table 2. shows that the percentage of firm value can be explained by leverage and profitability of 0.552 or 55.2% while 44.8% is explained by other factors. The acquisition of the R Square stock price value of 0.545 indicates that leverage, and profitability with firm value mediation is 0.545 or 54.5% while 45.5% is influenced by variables outside the study.

Table 3. Bootstrapping

Relationship	Original Sample (O)	P Values
Leverage -> Firm Value	0.129	0.117
Profitability -> Firm Value	0.699	0.000
Leverage -> Stock Price	-0.095	0.028
Profitability -> Stock Price	0.156	0.096
Firm Value -> Stock Price	0.641	0.001
Leverage -> Firm Value -> Stock Price	0.083	0.128
Profitability -> Firm Value -> Stock Price	0.448	0.003

Source: Output SmartPLS (2024)

Based on table 3. it is stated that leverage has no effect on firm value with P values of $0.117 > 0.05$. Profitability has a significant positive effect on firm value with a P value of $0.000 < 0.05$ and an original sample of 0.699 (positive). Leverage has a significant negative effect on stock price with P values of $0.028 < 0.05$ and an original sample value of -0.095 (negative). Profitability has no effect on stock price P values of $0.096 > 0.05$. Firm value has a significant positive effect on stock price with P values of $0.001 < 0.05$ and original sample value of 0.641 (positive). Firm value cannot mediate the relationship between leverage and stock price as indicated by the P values of $0.123 > 0.05$. Firm value can mediate the relationship between profitability and stock price as indicated by the P value of $0.003 < 0.05$.

Hypothesis 1 leverage on firm value leverage is not proven in the research results show that leverage has no effect on firm value. Trade-off theory states that companies try to balance the benefits and costs of using debt. Debt benefits include tax deductions due to deductible interest, while debt costs include bankruptcy risk and agency costs. If leverage has no significant effect on firm value, this could indicate that the firm has reached a balance point between the benefits and costs of debt. This means that adding or reducing debt will not significantly increase or decrease firm value because the company is already in an optimal position in its capital structure. In the context of the pecking order theory, leverage has no significant effect on firm value because firms tend to prioritize funding from internal sources such as retained earnings before considering external options such as debt or equity. This theory assumes that firms will use debt only if internal funds are insufficient, and will avoid issuing shares due to the cost of issuance and the negative signals it can send to the market. If companies have sufficient internal cash flow to meet their investment and operational needs, they do not need to rely on debt, so changes in the level of leverage have little effect on firm value. In other words, companies that follow the pecking order principle have low or stable leverage, so variations in leverage are not the main factor affecting firm value.

Based on the research results that show that leverage has no effect on Firm Value during this period, there are several reasons that can be identified. Before the pandemic, many firms had achieved a stable capital structure, so there was no need to significantly increase leverage. During the pandemic, economic uncertainty has made companies tend to refrain from increasing debt and focus more on cash flow management and the use of internal funding. After the pandemic, companies are more cautious in making financial decisions, including in terms of leverage, to maintain stability and anticipate potential future crises. Therefore, changes in leverage levels during the 2019-2023 period did not have a significant impact on firm value. The

results of this study are supported by the research of Aisyah & Djuanda (2022) and Nurmiati et al. (2019) found that leverage has no effect on firm value.

Hypothesis 2 profitability on firm value obtained results profitability has an influence on firm value positive significant. This result is relevant to the signaling theory that companies that succeed in increasing profits are considered to provide positive signals. A high level of profitability is interpreted as an indication of the company's ability to generate profits on an ongoing basis, which has the potential to provide good returns and ultimately contribute to an increase in firm value (Laksmi et al., 2024). Companies have the ability to generate high profits can increase trust and expectations of the company's future prospects so that investors give high valuations to the company. In addition, Agency Theory can also be used to explain the relationship between profitability and firm value. This theory states that there is a potential conflict of interest between management (agents) and company owners (principals). High profitability usually results from effective management and efficient resource management, which reduces the potential conflict between agents and principals. When the company shows good profitability, shareholders tend to believe more that management is working for their interests, so the risk of conflict decreases and firm value increases.

These results indicate that higher profitability increases investor confidence and reflects efficient management, thereby increasing the company's value. This finding is in line with the research of Syahputri et al. (2020) high profitability shows that the company manages investment effectively and generates profits according to the expected target. Profit is the company's main target to improve the welfare of shareholders. Profitability is used by investors to assess investment returns. Profits diverted for business expansion can increase future profits, which in turn increases the return value for shareholders. Profitability growth reflects the company's good prospects and attracts investor interest, so profitability has a positive influence on firm value.

Hypothesis 3 leverage on stock price is accepted that there is a negative effect of the leverage variable on stock price. Risk and Return Theory suggests that debt can increase a company's financial risk, which often has a negative impact on stock prices. When companies increase leverage, the risk of bankruptcy and higher interest expenses can reduce profitability and cash flow, which ultimately hurts investors. According to Junaeni (2017:33) investor interest can decrease if the company bears too much debt. Increased leverage is considered a negative signal for investors and stakeholders, which can cause stock prices to fall (Khasanah & Suwarti, 2022). Various considerations affect investors' investment decisions. The level of leverage can affect stock price fluctuations through market perceptions of financial risk. High leverage increases financial risk, which may cause investors to worry

about possible debt repayment difficulties. Interest and principal payment obligations that must be met even if the company experiences a decline in performance. These concerns usually have a negative impact on stock prices, as investors tend to avoid the shares of companies that are considered high risk. According to Brigham & Houston (2010:140) stock prices tend to fall with the increasing risk of using debt.

In the context of Trade-Off Theory, highly leveraged firms may face increased bankruptcy costs and agency costs. Companies with a capital structure that is heavier on debt tend to have lower stock prices because the market values the additional risk that the company is taking. This research shows that while debt can reduce taxes, high debt-related risks often offset those benefits, leading to a decline in stock prices. Referring to the 2019-2023 period, which includes the years before, during, and after the COVID-19 pandemic, the negative effect of leverage on stock prices can also be explained through the Pecking Order Theory. During the pandemic, many companies faced economic uncertainty and chose to reduce debt to manage financial risk. The results of this study are in line with Pratama & Marsono (2021), Putri & Yustisia (2021), and Adrianto (2024).

Hypothesis 4 Profitability on stock price is rejected that the test results show no effect of profitability on stock price. During a pandemic, investors may focus more on risk and uncertainty than short-term profitability, so the signal from high profitability is not enough to significantly affect stock prices. This study provides information on how well the company generates profits from shareholders' equity. The more the company generates profit from shareholders' equity, the better the company's performance in utilizing its capital and can provide benefits for shareholders. However, if the company's capital from loans is more than its own capital, it is also not profitable for investors because the company's profits will be paid to pay off the debt (Pangaribuan & Suryono, 2019). In the context of the Trade-Off Theory, which suggests that firms should balance between profits and costs, including the cost of debt and risk, high profitability does not always translate into increased share prices.

Investors do not only focus on profitability, there are many other factors that also affect stock prices. This shows that the company's ability to generate profits by utilizing its capital has not been able to become a reference for investors to make investment decisions. Profitability does not reflect the overall health and prospects of the company so that the market does not really respond to the results of the study in line with Djamaa & Awalia (2021) who found no effect of profitability on stock prices. These studies indicate that external factors such as market risk and economic uncertainty are often more dominant in influencing stock prices than good profitability, especially in industries that are severely affected by the global crisis. periods of economic

instability, such as those during the COVID-19 pandemic, investors may pay more attention to other factors such as operational stability and short-term financial health than profitability, which may cause profitability to have no significant effect on stock prices. This underscores how the macroeconomic context can affect the relationship between profitability and a firm's market value.

Hypothesis 5 firm value on stock price is accepted the results show that firm value has a positive effect on stock price. Signal Theory suggests that companies use certain information to signal investors about their performance and future prospects. High firm value is often considered a positive signal that the company is well managed, has solid financial performance, and good growth prospects. During the study period, companies with high values were often seen as more stable and able to cope with economic uncertainties, such as the COVID-19 pandemic, which caused their stock prices to tend to increase. In the years before, during and after the pandemic, manufacturing companies that managed to maintain or increase their value provided a strong signal to the market that they have the capacity to survive and thrive even in difficult economic conditions. As a result, investors will invest in the shares of such companies, which contributes to an increase in stock prices.

This is in line with the findings of Pradanimas & Sucipto (2022) which show that high firm value can encourage stock prices to rise. High firm value plays an important role in attracting investor interest, often interpreted as a sign that the company has good prospects and performance. This shows the management's ability to process resources optimally. Investors see companies with high value as a more profitable investment, which reflects market confidence in the company's ability. Signal Theory also suggests that companies that are able to increase their value through improved performance or successful growth strategies can use this information to attract investors. During the post-pandemic recovery period, companies that show increased value are often in the spotlight for investors looking for solid investment opportunities. The results of this study are in line with Kusumawardhani & Nugroho, (2019) and Aisyah & Djuanda (2022).

Hypothesis 6 leverage on stock price through firm value is rejected the results show that firm value is not able to be a variable that mediates the influence between leverage on stock price. high leverage can increase the financial risk faced by the company. If the risk is too high, even an increased firm value cannot effectively compensate for the negative impact of large debt. During the 2019-2023 period, including the COVID-19 pandemic, many firms face risks that cannot be fully managed even though they have high firm value. As a result, even though firm value increased, stock prices remained depressed by the risks associated with high leverage. Trade-Off Theory suggests that

firms must balance the benefits of debt, such as tax savings, and the costs of debt, including bankruptcy risk. If a firm is highly leveraged, the agency costs and associated risks may outweigh the benefits derived from debt. In this context, firm value may not serve as an effective mediating variable because high debt costs and risks may offset the potential benefits of high value.

Trade-Off Theory suggests that firms must balance between the benefits of debt, such as tax savings, and the costs of debt, including bankruptcy risk. If a firm is highly leveraged, the agency costs and associated risks may outweigh the benefits derived from debt. In this study, firm value does not serve as an effective mediating variable because high debt costs and risks may offset the potential benefits of high value. Investors focus more on the direct risks associated with leverage rather than the resulting firm value. During periods of high uncertainty, such as a pandemic, investors often assess debt risk directly, without taking into account firm value as a mediating variable. This suggests that the stock price will move towards its true intrinsic value. However, if high leverage causes great uncertainty or financial problems, firm value is not enough to mitigate the negative impact. Changes in leverage levels can directly affect the stock price without the need to be mediated by firm value. Stock price fluctuations are driven by investors' perception of the risk associated with the firm's debt level. In other words, investors may be more sensitive to the signals provided by the leverage ratio than to the long-term intrinsic value of the company. The results of this study are in line with those found by Aisyah & Djuanda (2022), Salim & Junaidi (2020) and Nainggolan et al. (2023).

Hypothesis 7 states that profitability on stock price through firm value is accepted, with the results showing that firm value is able to be a significant mediating variable between profitability and stock price. Referring to Signal Theory, companies often use information related to performance and future prospects to provide positive signals to the market. When a company shows high profitability, it sends a strong signal that the company is well managed, has high operational efficiency, and solid growth prospects. Firm value that increases as a result of high profitability then serves as an effective mediator, linking profitability with higher stock prices. Firm value acts as an intermediary that filters and amplifies the signal from profitability, as higher firm value indicates that the firm is able to generate stable profits and has good growth potential. This increase in firm value provides a stronger positive signal to investors, who tend to respond by increasing the stock price. In addition, the positive information generated from high profitability and increased firm value helps communicate growth potential and solid performance to the market, which in turn drives the stock price up in line with the higher firm value.

The results of this study are in line with the findings of Permatasari et al. (2019) which shows that an increase in profitability is usually followed by an increase in stock price, as higher firm value attracts investors who see the company as a more profitable investment. In this context, high profitability shows that the company is not only able to generate stable profits but also has promising growth prospects. When firm value increases due to good profitability, investors see the company as a more attractive investment opportunity, which in turn can significantly increase the share price. This confirms the importance of firm value as a mediating variable in the relationship between profitability and stock price, especially in the context of a dynamic and uncertain market.

Conclusion

Based on the empirical findings of this study, several key conclusions are drawn. First, leverage does not have a significant effect on firm value, supporting both the Trade-Off Theory and Pecking Order Theory. This suggests that firms may have reached an optimal capital structure or prefer internal financing over debt, thus limiting leverage's impact on firm value. Second, profitability exerts a significant positive influence on firm value, providing a strong signal of operational efficiency and sound management, in line with both signaling and agency theories. Third, leverage negatively affects stock prices due to increased financial risk, especially in uncertain economic environments such as the COVID-19 pandemic. Fourth, profitability does not directly influence stock prices, indicating that market conditions and external macroeconomic variables may moderate its impact. Fifth, firm value positively influences stock prices, highlighting its role as a key intermediary that strengthens investor trust and enhances stock valuation. Furthermore, firm value does not mediate the effect of leverage on stock price but does act as a significant mediator in the relationship between profitability and stock price.

These findings underscore the importance of financial structure optimization and profitability enhancement as core strategies for improving firm valuation and investor confidence. Managers should carefully manage debt levels and prioritize sustainable profit generation to maintain long-term stock value growth. This study opens several avenues for future research in the global context. Cross-country comparative studies can be conducted to explore whether the relationships among leverage, profitability, firm value, and stock price hold true in different regulatory environments and economic conditions. Additionally, future studies could incorporate macroeconomic indicators (e.g., interest rates, inflation, geopolitical risk) as moderating variables to assess how external shocks influence the financial-performance-valuation nexus. Another valuable direction would be the integration of ESG

(Environmental, Social, and Governance) metrics or corporate governance quality as control variables, particularly in global capital markets where sustainability and ethical practices increasingly influence investor decisions. Such global extensions would not only validate the robustness of the findings but also enrich the discourse on financial strategy and investor behavior across emerging and developed markets.

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