

## The Effect Of Profitability, Dividend Policy And Debt Policy On Firm Value

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### ABSTRACT

The firm value is the market value that can maximize shareholders' prosperity when the company's stock price increases. The firm value can be measured using the market value reflected in the stock price. The firm value is crucial as it reflects the company's performance, which can influence investors' perception of the company. This research aims to examine the impact of profitability, dividend policy, and debt policy on firm value. The population in this study consists of all companies listed in the LQ45 Index on the Indonesia Stock Exchange from 2016 to 2020. The research sample consists of 16 companies determined using purposive sampling method. The statistical tool SPSS version 24 is used to perform classical assumption tests, multiple linear regression analysis, and hypothesis testing. The research findings indicate that profitability and dividend policy have a significant positive effect on firm value, while debt policy does not have a significant effect on firm value when examined individually.

**Keywords :** Firm value, profitability, dividend policy, debt policy

### 1. INTRODUCTION

#### 1.1 Background

The current increasingly competitive era of globalization, both in the domestic and international markets, requires every company to compete and seize market opportunities in order to sustain its business. One way to seize market opportunities is by attracting investor attention. The main objective of a public company is essentially to enhance the prosperity of owners or shareholders through increasing the company's value.

Firm value is a crucial measure of the financial performance and attractiveness of a company in the eyes of its shareholders and potential investors. Several factors contribute to the determination of firm value, including profitability, growth prospects, risk profile, and the firm's capital structure. Among these factors, profitability, dividend policy, and debt policy play significant roles in shaping a firm's value. The price to book value is used as proxy to measure firm value in this study.

Probability, in the context of firm value, refers to the likelihood of achieving favorable outcomes or encountering adverse events. It encompasses both internal and external factors that can impact a firm's future cash flows and earnings. Internal factors may include the firm's competitive position, management expertise, and operational efficiency, while external factors involve macroeconomic conditions, industry trends, and regulatory environments. Understanding and effectively managing probability are crucial for firms aiming to maximize their value. In this study the proxy used to measure profitability is the return on equity (ROE) ratio.

Dividend policy is another vital aspect that influences firm value. It refers to the decisions and practices adopted by companies regarding the distribution of profits to shareholders in the form of dividends. Dividends represent a direct cash return to shareholders, and the dividend policy chosen by a firm can significantly impact its value. A company's dividend policy is shaped by various factors, including profitability, cash flow requirements for investments and operations, taxation considerations, and the preferences of shareholders. Different dividend policies, such as stable dividend payments, dividend growth, or no dividends, can have distinct effects on firm value and investor perception. The bird in the hand theory states that investors prefer cash dividends because cash in hand is more valuable than wealth in other forms. As a consequence, the stock price of a company will be greatly influenced by the amount of dividends distributed. The dividend policy in this research is measured by the dividend payout ratio (DPR).

Debt policy, or the capital structure of a company, refers to the mix of debt and equity used to finance its operations and investments. Debt policy has implications for the risk and return profile of a firm, which, in turn, affects its value. Companies can finance their activities by issuing debt (such as bonds or loans) or equity (shares or retained earnings). Debt financing introduces financial leverage, magnifying both returns and risks. Higher levels of debt can enhance a firm's return on equity if the company's investments generate a return higher than the cost of debt. However, excessive debt can also increase financial distress costs and limit financial flexibility, potentially leading to a decline in firm value. The debt policy in this research is measured by the debt to equity ratio (DER).

The interaction between probability, dividend policy, and debt policy is complex and interconnected. Companies need to strike a balance between these factors to optimize their value creation. For instance, firms with higher probability may be more attractive to investors, enabling them to access lower-cost debt and maintain a more generous dividend policy. Conversely, companies with high levels of debt may face higher borrowing costs, reducing their ability to distribute

dividends or invest in profitable projects. Understanding how these factors interplay and their impact on firm value is crucial for managers, investors, and researchers.

This research will be conducted on companies listed in the LQ45 index during the period of 2016-2020. The LQ45 index is a stock market index in the Indonesia Stock Exchange (IDX) consisting of 45 companies with the best liquidity and largest market capitalization. Investors tend to prefer investing in companies with a good track record in the capital market, and one of them is the companies included in the LQ45 index. The use of the LQ45 index can facilitate investors in choosing stock investments in terms of liquidity. It is said to be liquid because the movement of stock prices is influenced by the volume of stock transactions in the Indonesia Stock Exchange. This means that the stock is highly demanded by investors. Stocks that are highly demanded by investors will increase the demand for the stock, thus increasing the stock price. A high stock price will lead to an increase in the firm value.

## **1.2 Research problems**

Firm value is an important concept for investors because it serves as an indicator of how the market evaluates a company as a whole. Before making investments, investors need to gather information about the factors that can influence firm value as a basis for decision-making in their investment choices. The effect of profitability, dividend policy, and debt policy on firm value is a complex and multifaceted area that requires further investigation. The research conducted by Mardiyanti (2012) states that profitability has a positive effect on firm value. Sumanti and Mangantar (2015) states that dividend policy has a positive influence on firm value. On the other hand, Gultom and Syarif (2008) concludes that dividend policy does not affect firm value. Mardiyanti (2012) explains that the debt policy has a positive impact on firm value. This contradicts the study conducted by Yunita (2011), which states that debt policy does not have an influence on firm value.

## **1.3 Research Questions**

1. What is the effect of profitability on the firm value of companies included in the LQ45 index during the period 2016-2020?
2. What is the effect of dividend policy on the firm value of companies included in the LQ45 index during the period 2016-2020?
3. What is the effect of debt policy on the firm value of companies included in the LQ45 index during the period 2016-2020?

## **1.4 Research Purposes**

1. To analyze the influence of profitability on the firm value of companies included in the LQ45 index during the period 2016-2020.
2. To analyze the influence of dividend policy on the firm value of companies included in the LQ45 index during the period 2016-2020.
3. To analyze the influence of debt policy on the firm value of companies included in the LQ45 index during the period 2016-2020

# **2. LITERATURE REVIEW**

## **2.1 Signalling Theory**

Signaling theory is a concept in economics and finance that examines how individuals or firms communicate information to others in order to convey their quality, intentions, or characteristics. It is based on the idea that individuals or entities with asymmetric information (unequal knowledge) try to overcome this information asymmetry by sending signals to reveal valuable or credible information about themselves. In the context of finance, signaling theory suggests that firms can use various signals to convey information to investors, lenders, or other stakeholders about their financial health, future prospects, or managerial quality. These signals can affect the perceptions and decisions of these stakeholders, influencing their investment choices, lending decisions, or other interactions with the firm.

## **2.2 Firm Value**

Firm value represents the investors' perception of the company's level of success, closely associated with its stock price (Sujoko and Soebiantoro, 2007). A high stock price will result in a high firm value and enhance market confidence not only in the current performance of the company but also in its future prospects. Firm value is an important concept for investors, analysts, and stakeholders as it provides a measure of the company's worth and is used to assess its financial performance and attractiveness as an investment.

Firm value can be influenced by various factors, including profitability, growth prospects, industry dynamics, market conditions, competitive positioning, management quality, and risk profile. A company that generates higher profits, experiences consistent growth, and operates in a favorable market environment is likely to have a higher firm value. Conversely, factors such as poor financial performance, high risk, or unfavorable market conditions may lead to a lower firm value. Firm value is commonly used as a benchmark to evaluate the performance and attractiveness of companies within the same industry or sector. It is also used in financial analysis, investment decision-making, mergers and acquisitions, and other corporate finance activities. Investors and analysts often compare a company's firm value to its market capitalization (the total market value of its outstanding shares) to assess whether the company is overvalued or undervalued in the stock market.

There are various ratios that can be used to measure firm value, this study use price to book value. Price to book value (P/B) is a financial ratio used to evaluate the relationship between a company's market price per share and its book value per share. It compares the market value of a company's equity (as indicated by its stock price) to its net book value, which is the value of its total assets minus its total liabilities.

The P/B ratio provides insights into how the market values a company relative to its net asset value. A high P/B ratio suggests that the market values the company's future growth prospects and earnings potential more than its current net assets. It may indicate that investors have high expectations for the company's profitability and believe that its assets will generate significant returns in the future. Conversely, a low P/B ratio indicates that the market values the company below its net asset value. This may suggest that investors have lower expectations for the company's future earnings or that there are concerns about the company's financial health or growth prospects.

### **2.3 Profitability**

Profitability refers to a company's ability to generate profits or earnings relative to its expenses and costs of doing business. It is a key financial metric that indicates the efficiency and effectiveness of a company's operations in generating income and creating value for its shareholders. Profitability is typically measured using various financial ratios and metrics, including:

1. **Net Profit Margin:** This ratio represents the percentage of revenue that remains as net income after subtracting all expenses, including taxes and interest. It provides a comprehensive view of a company's overall profitability.
2. **Basic Earning Power:** Basic earning power is a financial ratio that measures a company's ability to generate operating income relative to its total assets, without considering the effects of taxes or financial leverage. It provides an indication of the company's operating efficiency and profitability.
3. **Return on Assets (ROA):** This ratio calculates the profitability of a company relative to its total assets. It indicates how efficiently a company utilizes its assets to generate profits.
4. **Return on Equity (ROE):** This ratio measures the profitability of a company relative to its shareholders' equity. It shows the return on investment for shareholders and reflects the company's ability to generate profits using shareholder funds.

Profitability is crucial for a company's financial health and sustainability. A profitable company is better positioned to fund its operations, invest in growth opportunities, attract investors, and reward shareholders with dividends or stock price appreciation.

### **2.4 Dividend Policy**

Dividend policy is a policy related to dividend payments by a company, which involves the decision of whether the company's earnings at the end of the year will be distributed to shareholders in the form of dividends or retained as retained earnings to increase capital for future investments. Therefore, an important aspect of dividend policy is determining the appropriate allocation of profits between dividend payments and retained earnings for the company's financial needs.

The implications of dividend policy are multifaceted, affecting both firms and investors. According to the signaling theory proposed by Bhattacharya (1979), firms paying higher dividends signal their positive future prospects, resulting in increased market confidence and higher stock prices. In contrast, the agency cost theory suggests that dividend payments can reduce agency conflicts between managers and shareholders, aligning their interests and ultimately enhancing firm value (Jensen and Meckling, 1976).

Additionally, studies have examined the impact of dividend policy on investor behavior and market reactions. Several researchers have explored the dividend signaling effect on stock prices and found evidence of a positive relationship between dividend increases and subsequent stock price appreciation (Lintner, 1956; Miller and Modigliani, 1961). Moreover, dividend policy has implications for investor preferences and the dividend yield as an investment criterion. Studies have shown that dividend-paying stocks tend to be more attractive to certain investor groups, such as income-focused investors or those seeking stable cash flows (Gordon, 1963).

Dividend payout ratio is used to measure dividend policy in this study. The dividend payout ratio is a financial metric that measures the proportion of earnings or net income distributed to shareholders in the form of dividends. It indicates the percentage of profits a company chooses to pay out to its shareholders rather than retaining them for reinvestment or other uses. The dividend payout ratio is calculated by dividing the total dividends paid by the company by its net income. The formula can be expressed as:

Dividend Payout Ratio = Dividends / Net Income

### **2.5 Debt Policy**

Debt policy is a crucial aspect of corporate finance that involves the decision-making process regarding the use of debt financing by companies such as issuing bonds or taking out loans, to finance its operations or investments. It plays a significant role in shaping a company's capital structure, financial stability, and risk profile. The relationship between debt policy and firm value can be complex and depends on several factors. Different theories and empirical studies have provided insights into this relationship:

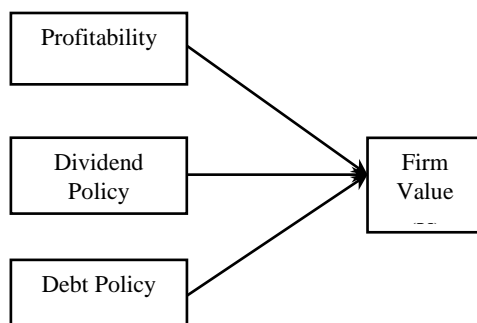
1. **Trade-off theory:** According to the trade-off theory, there is an optimal level of debt that maximizes firm value. Initially, as a company takes on more debt, the interest tax shield provides a benefit by reducing the company's tax obligations. This can lead to an increase in firm value. However, beyond a certain level, additional debt may increase

the risk of financial distress and bankruptcy costs, which can have a negative impact on firm value. Therefore, the trade-off theory suggests that there is a balance between the tax advantages of debt and the costs associated with financial distress.

2. Agency cost theory: The agency cost theory suggests that debt policy can influence the alignment of interests between shareholders and managers. Higher levels of debt can act as a disciplinary mechanism by increasing the monitoring and oversight of management. This alignment of interests can lead to better decision-making, improved operational efficiency, and ultimately increased firm value.
3. Pecking order theory: The pecking order theory posits that companies have a preference for internal financing (retained earnings) over external financing (debt or equity). According to this theory, companies prefer to use retained earnings first and resort to debt financing when internal funds are insufficient. The preference for internal financing is based on the notion that companies possess better information about their own prospects compared to external investors. By minimizing external financing needs, companies can reduce information asymmetry, signaling costs, and adverse selection problems, thus positively impacting firm value.

There are various ratios that can be used to as a proxy to measure debt policy, in this study debt to equity ratio is chosen as the proxy. The debt-to-equity ratio is a financial metric that compares a company's total debt to its total equity. It measures the proportion of a company's financing that is provided by creditors (debt) compared to shareholders (equity). The debt-to-equity ratio provides insights into the capital structure and financial leverage of a company.

### Conceptual Framework



### Hypothesis

- H1 : Profitability has a positive effect on firm value.
- H2 : Dividend policy has a positive effect on firm value.
- H3 : Debt policy has a negative effect on firm value.

## 3. RESEARCH METHODS

The type of research used in this study is associative research with a quantitative approach. Associative research aims to determine the relationship between two or more variables. Sample survey is used to collect data for this study. The population in this study consists of all companies listed in the LQ45 index during the period 2016-2020, totaling 68 companies. By using purposive sampling method, a sample that meets the criteria was obtained, comprising 16 companies from the population. SPSS ver. 26 is used as the tool to analyze the datas in this research.

## 4. RESULT AND DISCUSSION

### 4.1 Results of Data Analysis

#### 4.1.1 Descriptive Statistical Analysis

This descriptive statistical analysis aims to provide an overview (description) of a dataset, making the presented data easily understandable and informative. Descriptive statistics explain various characteristics of the data, such as the mean, standard deviation, minimum, and maximum values. In this study, descriptive analysis is conducted on the variables of profitability, dividend policy, debt policy, and firm value.

**Descriptive Statistics**

	N	Min.	Max.	Mean	Std. Deviation
ROE	80	.14	1.20	.4422	.20399
DPR	80	.28	1.33	.7112	.20964
DER	80	.39	2.57	1.2623	.69944
PBV	80	.35	9.08	2.0445	1.55985
Valid N (listwise)	80				

The table above shows that the number of data used in this study is 80 data observations taken from the financial statements of companies listed in the LQ45 index of the Indonesia Stock Exchange from 2016 to 2020. In terms of profitability, the ROE values range from a minimum of 0.14 (BBNI, 2020) to a maximum of 1.20 (UNVR, 2020), indicating variations in the companies' financial performance. The average ROE is 0.2366 with a standard deviation of 0.28929, providing an overview of the data distribution. Regarding dividend policy, the DPR values range from a minimum of 0.28 (BBCA, 2016) to a maximum of 1.33 (INTP, 2019). These figures represent the dividend distribution percentages of the companies in the study. The average DPR is 0.5493 with a standard deviation of 0.32908, reflecting the variation in dividend policies among the companies. In terms of debt policy, the DER values range from a minimum of 0.39 (INTP, 2016) to a maximum of 6.61 (BBNI, 2020). These values indicate the companies' debt levels, with INTP having the lowest debt usage and BBNI having the highest. The average DER is 2.0764 with a standard deviation of 2.09660, suggesting variations in the companies' debt structures. Lastly, firm value, measured by PBV, ranges from a minimum of 0.35 (AKRA, 2020) to a maximum of 9.08 (UNVR, 2017). PBV values represent the market's valuation of a company's stock relative to its actual price. The average PBV is 6.5829 with a standard deviation of 13.90097, reflecting the dispersion in market valuations.

#### 4.1.2 Normality test

A normality test is a statistical test used to determine whether a given dataset follows a normal distribution. The normal distribution, also known as the Gaussian distribution or bell curve, is a symmetric probability distribution characterized by its shape, mean, and standard deviation. This study used Kolmogrov-Smirnov method.

**Hasil Uji Kolmogrov Smirnov**

			Unstandardized Residual
N			80
Normal Parameters <sup>a,b</sup>	Mean		.0000000
	Std. Deviation		.55729859
Most Extreme Differences	Extreme Absolute		.055
	Positive		.055
	Negative		-.039
Test Statistic			.055
Asymp. Sig. (2-tailed)			.200 <sup>c,d</sup>

After performing data transformation using the square root (SQRT(X)) form, the original asymp. sig value (2-tailed) of 0.000 changed to 0.200. The results of the data transformation show that the asymp. sig value (2-tailed) is now greater than 0.05, indicating that the transformed data is normally distributed. This indicates that the data transformation has successfully converted the originally non-normally distributed data into data with a normal distribution.

#### 4.1.3 Multicollinearity test

Model		Collinearity Statistics	
		Tolerance	VIF
1	ROE	.894	1.119
	DPR	.776	1.289
	DER	.855	1.169

a. Dependent Variable: PBV

Based on the table above, we can see the tolerance and Variance Inflation Factor (VIF) values for each independent variable. The profitability, dividend policy, and debt policy variables all have tolerance values > 0.10 and VIF values < 10, indicating the absence of multicollinearity.

#### 4.1.4 Autocorrelation test

#### 4.1.5 Heteroscedasticity test

**Coefficients<sup>a</sup>**

Model		t	Sig.
1	(Constant)	-2.332	.022
	ROE	.976	.332
	DPR	.078	.938
	DER	-.632	.529

a. Dependent Variable: LnRES\_2

Heteroscedasticity test in this study was conducted using the Park method. Based on the table above, it can be observed from the data analysis results that all variables do not exhibit heteroscedasticity because the significance values of all variables are greater than 0.05.

#### 4.1.6 Hypothesis testing

**Coefficients<sup>a</sup>**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-1.741	.312		-5.589	.000
ROE	6.809	.331	.890	20.539	.000
DPR	.915	.346	.123	2.642	.010
DER	.099	.099	.044	1.000	.320

a. Dependent Variable: PBV

Based on the results of the testing in the table above, the regression coefficient of the Return on Equity (ROE) variable is 6.809 with a significance level of  $0.000 < 0.05$ . This indicates that profitability has a positive effect on firm value. The regression coefficient of the Dividend Payout Ratio (DPR) variable is 0.915 with a significance level of  $0.010 < 0.05$ . This indicates that dividend policy has a positive effect on firm value. The regression coefficient of the Debt to Equity Ratio (DER) variable is 0.099 with a significance level of  $0.320 > 0.05$ . This indicates that the debt policy does not have a significant effect on firm value.

#### 4.1.7 Determinant Coefficient (R<sup>2</sup>)

##### Adjusted R<sup>2</sup>

Model Summary <sup>b</sup>				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.934 <sup>a</sup>	.872	.867	.56819

It can be observed that the R-square value is 0.867, which means 86.7% of the variation in firm value is explained by the variables of profitability, dividend policy, and debt policy, while the remaining 13.3% is explained by other factors beyond the variables in this study.

#### 4.1.8 Multiple Linear Regression

Based on the results of linear regression testing, the influence of the independent variables on firm value can be determined using the following equation:

$$PBV = -1.741 + 6.809 ROE + 0.915 DPR + 0.099DER.$$

The equation above means: a) The constant value of -1.741 is the intercept term or the constant value in the equation. It indicates the estimated firm value when all independent variables (ROE, DPR, DER) are zero b) The coefficient value for profitability is 6.809. The positive sign indicates that the profitability variable has a positive relationship with firm value c) The coefficient value for dividend policy is 0.915. The positive sign indicates that the dividend policy variable has a positive relationship with firm value d) The coefficient value for debt policy is 0.099. The positive sign indicates that the debt policy variable has a positive relationship with firm value.

## 4.2 Discussion

### 4.2.1 The effect of profitability on firm value

The hypothesis test results indicate that profitability has a significant effect on firm value, as evidenced by the significant level of 0.000 and a coefficient value of 6.809. Therefore, it can be concluded that the formulated hypothesis aligns with the research findings, and the first hypothesis is accepted. A higher profitability level of a company, accompanied by a continuous increase in its earnings, indicates that the company is performing well. This, in turn, creates a positive signal that is favorable for investors. Profitability is an important indicator of a company's financial performance and its ability to generate earnings. When a company is profitable, it signifies that it is effectively managing its resources, generating sufficient revenues, and controlling its costs and expenses. This attracts investors and increases their confidence in the company's potential for future growth and profitability. The positive effect of profitability on firm value suggests that investors consider profitability as a crucial factor in evaluating and valuing a company. It indicates that companies with higher profitability are perceived to be more valuable in the market, potentially leading to higher stock prices and market capitalization. This research is consistent with the study conducted by Dewi et al. (2014), which states that profitability has an effect on firm value, similar to the findings expressed by Hermuningsih (2013), who states that profitability has a significant impact on firm value.

### 4.2.2 The effect of dividend policy on firm value

The hypothesis test results indicate that dividend policy has a significant effect on firm value, as evidenced by the significant level of 0.01 and a coefficient value of 0,915. Therefore, it can be concluded that the formulated hypothesis aligns with the research findings, and the second hypothesis is accepted. This indicates that the higher the dividends paid, the higher the value of the company. This is in line with the bird in the hand theory, which states that investors prefer high dividend income over capital gains because dividends provide certainty of returns and have lower risks. The profits gained by investors determine their well-being, which is the primary goal of the company. Dividend distribution serves as a positive signal that creates expectations among investors regarding the prospects of the company and reflects the good performance of the company's managers. The higher the dividends paid, the greater the interest of investors in investing their capital. As a result, the increased demand for the company's shares leads to an increase in share prices and ultimately reflects an increased firm value. The results of this study are consistent with the research results of Wongso (2012), Susanti (2010), and Rahardjo (2013), which indicate that dividend policy has a significant positive impact on firm value.

### 4.2.3 The effect of debt policy on firm value

The third hypothesis of this study states that debt policy has a negative effect on firm value. Based on the hypothesis testing results, the coefficient value is 0.099 with a significance level of 0.320. This indicates a positive direction but insignificant influence. Therefore, it can be concluded that the third hypothesis is rejected. The results of the study indicate that the debt policy does not have a significant negative impact on firm value. Although there is a positive direction in the relationship between debt policy and firm value, the lack of statistical significance suggests that the influence is not strong enough to draw meaningful conclusions. This implies that in the context of the study, the level of debt taken by companies does not have a significant impact on their overall value. Other factors, such as profitability and dividend policy, may play a more dominant role in determining firm value. The positive direction of the hypothesis testing results suggests that higher debt usage increases firm value. The trade-off theory explains that debt usage provides benefits in the form of tax reduction, which can increase after-tax earnings. The increase in earnings has an impact on the increase

in firm value. However, the lack of significance in the debt policy indicates that the level of debt-to-equity ratio (DER) does not have any implications on the level of firm value.

In this study, the signaling theory does not apply to the DER variable because the high or low DER is not a factor influencing investor interest in investing their capital. Investors evaluate how well a company utilizes debt for its operational activities. Investors should be careful in interpreting the DER value as each industry has different parameters regarding what constitutes a good or bad DER value. The results of this study are consistent with the research conducted by Sofyaningsih and Hardiningsih (2011), which states that debt policy does not have a significant influence on firm value.

## 5. CONCLUSION AND SUGGESTION

### 5.1 Conclusion

1. Profitability (ROE) has a significant positive effect on firm value (PBV). This indicates that higher ROE leads to an increase in PBV. High profits send a signal to investors that the company has good prospects, which attracts them to invest in the company.
2. Dividend policy (DPR) has a positive effect on firm value (PBV). This means that a higher dividend payout increases the firm's value because dividend distribution serves as a positive signal to investors regarding the company's prospects and reflects the good performance of the company's managers.
3. Debt policy (DER) does not have a significant effect on firm value (PBV). This implies that the level of DER does not influence the increase or decrease in PBV. The lack of significance in this result is due to the fact that each company in different sectors has a unique capital structure according to its specific needs.

### 5.2 Suggestion

1. For future researchers, it is recommended to increase the sample size and observation period by using stock market indices other than the LQ45 index and incorporating data from more than five years to ensure that the study reflects long-term conditions.
2. Future studies are expected to further develop the research by adding independent variables or even considering other variables that influence firm value apart from profitability, dividend policy, and debt policy.

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