



# The Influence of Profitability, Liquidity, and Capital Structure on Stock Prices Through Signaling Theory

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## Abstract

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This study aims to examine the influence of profitability, liquidity, and capital structure on stock prices from the perspective of signaling theory. Financial information disclosed by companies serves as an important signal for investors to assess performance, prospects, and potential investment risks. Profitability reflects the company's efficiency in generating income and provides a positive signal that can lead to an increase in stock prices. Conversely, a non-optimal capital structure may heighten financial risk and send a negative signal to the market, potentially reducing firm value. Liquidity also plays a crucial role, as it indicates the company's ability to meet short-term obligations and maintain financial stability, which is interpreted by investors as a sign of sound financial management. This research applies a library research approach by analyzing various relevant academic studies. The findings indicate that profitability, liquidity, and capital structure significantly influence stock prices, although the degree of their effects varies depending on company performance and market perception.

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## **1. Introduction**

Corporate financial information plays a crucial role in supporting investment decision-making processes. Investors require transparent and reliable financial reports to assess a company's performance, stability, and future prospects. Based on signaling theory, the information conveyed through financial reports serves as a signal given by the company to the market to minimize information asymmetry between management and investors (Sari & Sedana, 2020). Positive signals, such as increased profitability and a proportional capital structure, are generally responded to positively by investors through increased demand for the company's shares. This positive response is ultimately reflected in an increase in stock prices in the capital market.

Profitability is one of the main indicators reflecting the company's ability to generate profit from its operational activities (Wibowo, 2021). A high level of profitability indicates management efficiency in utilizing assets and illustrates the company's capacity to provide optimal returns to shareholders. Research conducted by Chandra et al. (2019) shows that an increase in profitability provides a positive signal regarding company performance, which subsequently impacts the rise in stock prices. From a signaling theory perspective, this condition indicates that company management uses the level of profit as a means of communicating favorable business prospects to investors regarding future expectations.

In addition to profitability, liquidity also plays a strategic role in reflecting the company's ability to meet its short-term obligations. A high level of liquidity signifies cash flow stability and efficient management of current assets, which is interpreted

by investors as a positive signal of the company's financial stability. According to the findings of Reschiwati et al. (2020), liquidity positively influences company value because it increases investor confidence in the company's ability to maintain its solvency. Thus, companies with adequate liquidity are considered to have lower financial risk, thereby tending to attract greater investment interest. The financial stability shown through healthy liquidity can ultimately strengthen the company's reputation in the eyes of the market.

Another factor that influences investor perception is capital structure. The Debt to Equity Ratio (DER) illustrates the company's funding strategy in balancing risk and return. An optimal capital structure signifies that the company is capable of managing debt burden effectively and wisely utilizing the tax benefits (tax shield) from the use of debt (Afinindy et al., 2021). However, a capital structure that relies too heavily on debt financing can send a negative signal because it potentially increases the risk of default and earnings volatility. Therefore, investors usually assess the balance between debt and equity components as a key indicator for evaluating the company's long-term stability.

In the context of the Indonesian capital market, the relationship between profitability, liquidity, and capital structure on stock prices still shows diverse results. Some studies find a significant influence between these three variables on company value and stock prices (Putro & Risman, 2021), while others indicate different results, depending on the industry sector and observation period. These varied findings show that the influence of financial factors on stock prices is contextual and

highly influenced by macroeconomic conditions, industry characteristics, and the managerial strategies implemented by each company.

Based on this background, this research aims to analyze the influence of profitability, liquidity, and capital structure on stock prices through the perspective of signaling theory. This approach is important because signaling theory provides a conceptual framework that explains how company management uses financial information as a strategic communication tool to the market. Investors can interpret these signals to make more rational and information-based investment decisions. Thus, this research is expected to strengthen empirical evidence regarding the influence of financial signals on investor perception and behavior in the capital market, particularly in Indonesia, while contributing theoretically to the development of modern financial literature emphasizing the importance of transparency and information credibility in the capital market mechanism.

## **2. Literature Review**

### **2.1. Profitability and its Influence on Stock Prices**

Profitability is a measure reflecting the company's ability to generate profit through its operational activities. This ratio plays a vital role in assessing the efficiency and effectiveness of managing the company's assets. A high level of profitability is a positive indicator of management success in optimally managing resources, and provides a favorable signal to investors regarding company performance and sustainability prospects. Based on signaling theory, management uses profit information as a communication tool to show a solid financial condition

and potential for continuous growth (Sari & Sedana, 2020). Research conducted by Chandra et al. (2019) indicates that profitability has a positive effect on stock prices for companies included in the Kompas 100 index.

This is due to the high profit level reflecting operational efficiency and the potential for greater dividend distribution, thereby increasing investor appeal for the company's stock. Furthermore, the results of Reschiwati et al. (2020)'s study also affirm that increased profitability significantly contributes to an increase in company value, especially when accompanied by effective capital management and measured financial strategies. From a signaling theory perspective, companies capable of conveying positive financial performance will attract market attention because they are considered to have promising growth prospects. Conversely, a decrease in profitability is often interpreted as a negative signal regarding the company's inability to maintain profit stability. Therefore, profitability is one of the fundamental indicators that influences investor perception and has a direct implication for stock price dynamics in the capital market.

## **2.2. Liquidity as an Indicator of Financial Stability**

Liquidity refers to the company's ability to meet its short-term obligations using its current assets. In signaling theory, high liquidity is viewed as a positive signal because it indicates financial stability and the company's ability to maintain its operational continuity. Investors tend to rate companies with high liquidity levels as entities with low bankruptcy risk. Research by Putro and Risman (2021) shows that liquidity significantly influences company value, both directly and through profitability as a mediating variable. Meanwhile, Sari and Sedana (2020) found that

liquidity can increase investors' positive perception of the company, as it indicates management's ability to maintain a balance between assets and liabilities.

However, the relationship between liquidity and stock prices is not always linear. Bajaj et al. (2021) explain that excessively high liquidity can indicate inefficiency in asset utilization, as the company is not maximizing its investment potential. Therefore, an optimal liquidity balance is needed so that the company maintains financial flexibility without sacrificing growth opportunities. Liquidity is also closely related to the company's access to external financing. In an efficient capital market, companies with high liquidity levels will gain greater trust from investors and creditors, thus facilitating the funding process. This relationship strengthens liquidity's position as a signal that influences investor behavior and stock price dynamics.

### **2.3. Capital Structure and its Implications for Stock Prices**

Capital structure describes the proportion between debt and equity in financing the company's activities. According to signaling theory, a company's financing decisions convey a message to the market regarding management's confidence in its business prospects. The use of debt in the capital structure can be interpreted as a positive signal if it shows management's conviction in the company's ability to generate profit to pay off these obligations (Afinindy et al., 2021). However, a capital structure with an overly high proportion of debt can generate a negative signal because it increases financial risk. Reschiwati et al. (2020) affirm that excessive debt ratio can reduce company value due to increased interest expense and bankruptcy risk.

Conversely, a balanced capital structure will increase company value through the tax shield effect and optimization of the cost of capital. Research by Sarumpaet and Suhardi (2020) indicates that capital structure has a positive influence on profitability and stock returns, suggesting that strategic financing decisions can increase investor confidence. In addition, Putro & Risman (2021) confirm that capital structure acts as a mediating variable between liquidity and company value. The conclusion from the literature shows that profitability, liquidity, and capital structure are interrelated and collectively serve as key signals in stock price formation. The combination of high profit levels, maintained liquidity, and an efficient capital structure will create a positive perception of company value, which ultimately encourages an increase in stock prices in the capital market.

### **3. Method**

This research uses a library research approach, which is a research method carried out through systematic review of various scientific literature sources relevant to the study topic. This approach was chosen because the main focus of the research lies in the conceptual understanding and theoretical analysis of the relationship between the variables of profitability, liquidity, and capital structure on stock prices from the perspective of signaling theory. This method allows researchers to integrate and synthesize findings from previous research to build a comprehensive conceptual argument supported by well-tested empirical evidence. The research stages begin with the process of collecting secondary data from various credible academic sources, such as journal articles, proceedings, and published research reports. Data

is obtained through scientific databases, including Google Scholar, ResearchGate and other academic repositories.

Literature selection is done selectively based on criteria of relevance to the research variables, the use of signaling theory as a conceptual foundation, and discussions covering the relationship between company financial factors and stock prices. The next stage is descriptive qualitative analysis, which aims to deeply examine the content of each collected literature. This analysis process is carried out by identifying the similarities, differences, and contributions of each study to the development of understanding of signaling theory in the context of the capital market. In addition, a review is also conducted on the methodology used in previous studies, the resulting findings, as well as the theoretical and practical implications contained therein. Through this approach, the research results are expected not only to be synthetic but also to provide a critical view of the extent to which signaling theory can explain market behavior towards company financial indicators.

The collected literature is then classified based on three main variables, namely profitability, liquidity, and capital structure, to assess the level of consistency of previous research results. Furthermore, researchers interpret the interrelationship between these variables in an empirical and theoretical context, and identify the research gap that still requires further study. This library research approach emphasizes theoretical validity through strict source selection and the use of references from indexed journals. The advantage of this method lies in its ability to explore conceptual and empirical relationships in depth without requiring primary data collection. The results of the analysis are expected to provide a strong scientific

basis for understanding how profitability, liquidity, and capital structure function as financial signals that influence investment decisions and stock price dynamics in the capital market.

#### **4. Results**

The results of the literature analysis show that the relationship between profitability, liquidity, and capital structure on stock prices within the framework of signaling theory is complex and dynamic. These three variables not only individually influence stock prices but also interact simultaneously in shaping investor perception of a company's value. In general, the literature review results indicate that financial information conveyed by the company serves as an important means to reduce information asymmetry and create market signals that influence investor behavior.

Profitability is the most consistent variable showing a positive influence on stock prices. Natsir and Yusbardini (2020) confirm that companies with high profitability levels provide a positive signal regarding future business prospects, thereby encouraging an increase in stock prices. Investors interpret profitability as an indicator of operational efficiency as well as the company's ability to generate stable profit and provide the potential for greater dividend distribution. Within the signaling theory framework, management strategically uses financial reports showing high profit performance as a form of communication regarding confidence in business sustainability. This signal is usually received positively by the market because it is considered to reflect the company's ability to maintain a sustainable profit level.

In line with these results, Sarumpaet and Suhardi (2020) state that profitability is closely related to stock returns, where an increase in Earnings per Share (EPS) directly contributes to an increase in stock prices. Investors tend to choose stocks from companies with high profitability ratios because they are considered to have stable and sustainable growth prospects. This condition confirms that the market responds positively to profit information as a signal that describes confidence in company performance. Research conducted by Listyaningsih (2020) also reinforces this view by showing that profitability significantly affects company value, especially if accompanied by efficient and transparent capital management.

However, not all studies show a strong relationship between profitability and stock prices. Zuhroh (2019) found that the influence of profitability on company value is not always significant when mediated by capital structure and liquidity. This indicates that although profitability can be a positive signal, its impact on stock prices highly depends on other supporting factors such as financial stability and the company's financing policy. In other words, the signal generated from profitability does not always directly impact stock prices without considering the managerial context or the surrounding macroeconomic conditions.

Liquidity is also an important factor that influences investor perception of company performance and risk. Companies with high liquidity levels are generally considered to have a good ability to meet short-term obligations, which reflects a healthy financial condition. Based on signaling theory, the company's ability to maintain its liquidity is a positive signal to investors regarding operational stability. Afinindy et al. (2021) state that liquidity has a negative relationship with capital

structure, which means the higher the liquidity level, the lower the company's dependence on external financing through debt. This condition positively impacts stock prices because it reduces financial risk and strengthens investor confidence in company management.

Research conducted by Nurwulandari (2021) also shows that liquidity significantly influences company value, both directly and through capital structure as an intervening variable. This finding shows that liquidity can reinforce the influence of profitability on stock prices by creating investor confidence in the company's ability to manage liabilities and assets efficiently. In investment practice, investors generally assess liquidity through the current ratio or quick ratio to ensure the company's ability to maintain positive cash flow in the short term. Nevertheless, the relationship between liquidity and stock prices is not always linear or positive. Excessively high liquidity levels can be interpreted as an indication that the company has not optimized its current assets for productive investment. In this context, the market may assess that management is less efficient in allocating the resources it possesses. Therefore, the ideal liquidity level is a condition where the company is able to balance short-term financial flexibility with long-term operational efficiency and profitability.

Furthermore, capital structure also plays a significant role in explaining stock price movements. The Debt to Equity Ratio (DER) is often used as an indicator to assess the level of financial risk and the company's ability to manage debt obligations. Based on signaling theory, the use of debt can provide a positive signal if it reflects management's confidence in future profit prospects. Conversely, an excessively high

debt level can be interpreted as a negative signal that increases the risk of default and lowers the stock value in the eyes of investors.

Mansyur et al. (2020)'s research shows that capital structure has a significant influence on stock prices in the banking sector in Indonesia, with profitability acting as a mediating variable. These results support the view that company financing decisions have important implications for market perception, where investors tend to respond positively to efficient financing strategies accompanied by financial transparency. Meanwhile, Zuhroh (2019) affirm that an optimal capital structure can increase company value by maximizing the tax benefits from the use of debt without creating excessive financial risk. These findings show that the signals arising from capital structure can be dual in nature. When the company uses debt in reasonable proportion, the market views it as a sign of management confidence in the company's ability to generate profit. However, when the debt level exceeds the optimal limit, the market will interpret this condition as a negative signal indicating financial pressure. Thus, balance in capital structure management is a key factor in maintaining investor confidence and positive perception.

The synthesis of previous research results shows that signaling theory is a strong theoretical approach in explaining the relationship between main financial variables profitability, liquidity, and capital structure on stock prices. Companies that are able to send positive signals through increased profitability, effective liquidity management, and a balanced capital structure will more easily gain investor confidence. Conversely, negative signals arising from unstable profit, decreased liquidity, or excessive use of debt will reduce the appeal of stocks in the capital

market. Furthermore, previous research also highlights the importance of external factors such as macroeconomic conditions, interest rates, and monetary policy that can strengthen or weaken the influence of these three variables on stock prices. For example, in unstable economic situations, investors tend to be more cautious and become more sensitive to financial information released by the company.

This shows that the effectiveness of financial signals is not only determined by the company's internal performance but also by external conditions that affect investor expectations regarding risk and investment returns. Thus, it can be concluded that the influence of profitability, liquidity, and capital structure on stock prices is complementary and dynamic. Signaling theory provides a comprehensive conceptual basis for understanding how financial information functions as a strategic communication tool between company management and investors. When the signal sent by the company is consistent, credible, and supported by stable financial performance, the market will respond positively, which is reflected in an increase in stock prices and overall company value.

## 5. Discussion

The results of the literature study indicate that signaling theory is an important basis for understanding how profitability, liquidity, and capital structure influence stock prices. In this context, signaling theory explains that financial information conveyed by the company through annual reports and performance publications is a form of communication between management and the market to reduce

information asymmetry. Investors interpret every financial indicator as a signal, whether positive or negative, which will influence investment decisions.

High profitability becomes a positive signal because it shows the company's ability to generate sustainable profit. Investors assess that companies with good financial performance have greater growth potential and lower risk levels. The findings of Natsir and Yusbardini (2020) confirm that increased profitability tends to boost investor confidence and impacts stock price increases. However, the study by Siahaan et al. (2021) shows that this relationship can be mediated by capital structure, meaning the influence of profitability on stock prices will be stronger if the company has a sound and efficient financing policy.

Liquidity is also proven to play an important role in building market perception. Companies with high liquidity levels send a signal that they are capable of meeting their short-term obligations and maintaining cash flow stability. This creates a perception of security for investors. According to Listyaningsih (2020), the company's ability to maintain its liquidity is a determinant of market confidence in the company's financial management. However, if liquidity is too high, the market may interpret it as a sign that the company is not optimizing current assets for productive expansion or investment, which ultimately lowers operational efficiency.

Capital structure also gives a strong signal regarding the perception of risk and stock value. Management's decision to use debt in a certain proportion is often interpreted as a form of self-confidence in the company's ability to generate future profit. Afinindy et al. (2021) explain that an optimal capital structure creates a positive signal to the market, as it shows careful risk management and tax efficiency

through the tax shield. Conversely, excessive use of debt can create a negative signal indicating financial pressure and lowering investor interest.

The literature results show that the combination of high profitability, balanced liquidity, and optimal capital structure creates a positive signal that strengthens investor perception of company value. However, it is important to note that the effectiveness of the signal highly depends on the consistency and credibility of the information conveyed by the company. Lack of clarity or manipulation of financial information can damage market confidence and lead to negative signals. Thus, the application of signaling theory in corporate financial practice demands transparency, accountability, and good governance to maintain investor confidence and stock price stability in the capital market.

## 6. Conclusion

Based on the results of the literature study conducted, it can be concluded that profitability, liquidity, and capital structure are the main variables that influence company stock prices from the perspective of signaling theory. High profitability sends a positive signal to the market that the company is capable of generating profit consistently and has good growth prospects. This increases investor confidence and encourages an increase in stock prices. Liquidity plays an important role in demonstrating the company's ability to meet its short-term obligations. An optimal liquidity level is an indicator of financial stability and cash management efficiency, which ultimately strengthens investor confidence in the company. Meanwhile, an

efficient capital structure through a balance between debt and equity shows the company's ability to manage financial risk and effectively utilize tax benefits.

These three variables interact with each other in creating signals interpreted by the market. In the context of signaling theory, companies that are able to manage profitability, liquidity, and capital structure well will be considered to have strong financial governance, thereby attracting investor interest and increasing their stock market value. Conversely, negative signals arising from a decline in profitability, unstable liquidity, or an overly aggressive capital structure can reduce market perception of the company's value. Thus, transparency and consistency in the delivery of financial information are the main keys for the signal sent by the company to be received positively by the market and impact the increase in stock value.

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