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Financial Slack, Corporate Reputation, and Financial Performance: Exploring Mediating Mechanisms in the Creation of Firm Value

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Abstract

Firm value represents one of the most critical measures of business success, reflecting investor perceptions of growth potential and managerial capability. While financial slack, defined as excess financial resources beyond operational needs, has been recognized as a strategic buffer that provides flexibility and resilience, empirical studies show inconsistent results regarding its influence on firm value. This study addresses the research gap by examining the mediating role of corporate reputation and financial performance in the relationship between economic slack and firm value, grounded in the resource-based view (RBV) and stakeholder theory.

The research employs an explanatory quantitative design using data from 143 firm-year observations of non-financial companies listed on the Indonesia Stock Exchange (IDX) during 2021–2023. Variables were measured using free cash flow (financial slack), the Corporate Image Index (reputation), return on assets and return on equity (financial performance), and Tobin's Q (firm value). Analytical techniques included path analysis and Sobel tests to assess direct, indirect, and total effects.

Results demonstrate that financial slack positively influences both corporate reputation and financial performance. In turn, reputation and performance significantly enhance firm value. The findings further confirm that the impact of financial slack on firm value is largely indirect, mediated through these variables. This provides evidence that slack resources must be strategically managed to generate intangible advantages and operational efficiency that ultimately increase market valuation.

This study contributes to the literature by clarifying inconsistent findings on financial slack, integrating RBV and stakeholder perspectives, and highlighting the importance of intangible and performance-based mediators. For practitioners, the results emphasize that idle resources should not be perceived as inefficiencies, but rather as strategic reserves that, when allocated effectively, strengthen reputation, improve performance, and drive long-term shareholder wealth.

Keywords: Financial Slack; Corporate Reputation; Financial Performance; Firm Value

1. Introduction

Firm value is widely regarded as a central indicator of corporate success and investor confidence. It reflects the market's assessment of a company's ability to generate future returns and is often proxied by stock price performance. A higher firm value not only benefits shareholders through capital gains but also signals managerial effectiveness and sustainable business prospects. In emerging markets such as Indonesia, where volatility and competition are intense, firm value plays a critical role in determining investor trust and market positioning (Bebbington et al., 2008; Cho et al., 2012; Hong et al., 2000; Hyndman & McKillop, 2018).

One determinant often linked to firm value is financial slack, defined as excess resources beyond operational requirements. Financial slack allows firms to act flexibly in uncertain environments, supporting innovation, strategic investment, and resilience against shocks. For instance, companies with strong free cash flow can allocate resources to research and development, corporate social responsibility, or acquisitions that enhance competitiveness. The role of financial slack is paradoxical: while some studies suggest it strengthens long-term sustainability, others argue it encourages inefficiency or wasteful investments that destroy value (Balachandran & Faff, 2015; de Jong et al., 2021; Derrien et al., 2021; Khan & Shoaib, 2024; OHLSON, 1995).

This divergence in findings underscores the need to examine mechanisms through which slack resources influence firm value. Two promising mediating variables are corporate reputation and financial performance. Reputation represents

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an intangible asset built over time through consistent delivery of quality, ethical behavior, and stakeholder engagement. A strong reputation enhances legitimacy, attracts investors, and differentiates firms in competitive markets. Meanwhile, financial performance provides tangible evidence of managerial effectiveness and operational efficiency, serving as a direct signal to investors regarding firm quality and growth prospects.

Theoretically, this study draws upon the resource-based view (RBV), which emphasizes that valuable, rare, inimitable, and organized resources form the foundation of sustainable competitive advantage(Andersén, 2021; Holcomb & Hitt, 2007; McIvor, 2009; Neves et al., 2014). Financial slack, when strategically managed, can be transformed into intangible capabilities such as reputation and into measurable outcomes such as profitability. Complementing this, stakeholder theory posits that firms must satisfy diverse stakeholder expectations to secure long-term survival. Financial slack can facilitate stakeholder-oriented initiatives such as social responsibility or innovation that enhance reputation and performance, ultimately driving firm value. (de Jong et al., 2021; Mishina et al., 2004)

Despite growing interest, research on financial slack in the Indonesian context remains limited. Prior studies provide mixed evidence: some report positive associations with firm performance and value, while others find insignificant or negative effects. This inconsistency suggests that direct relationships may be insufficient to capture the complexity of slack's influence (David-West et al., 2018; Erdoğan et al., 2020; Gulbrandsen et al., 2009; Mishina et al., 2004). By introducing corporate reputation and financial performance as mediators, this study aims to clarify the pathways through which slack resources affect firm value.

Accordingly, the present research focuses on non-financial companies listed on the Indonesia Stock Exchange (IDX) between 2021 and 2023, a period characterized by economic recovery and heightened market uncertainty following the COVID-19 pandemic. The study seeks to answer whether financial slack contributes to firm value directly or indirectly through enhancing corporate reputation and financial performance.

This research contributes to the literature by (1) providing empirical evidence from an emerging market setting, (2) integrating RBV and stakeholder theory in explaining the transformation of slack resources into value, and (3) offering managerial insights on how to allocate excess resources to build intangible and financial strengths that boost market valuation.

2. Methodology

2.1 Research Design

This research uses an explanatory quantitative design, which is appropriate for testing theoretical relationships among variables. The objective is to analyze the causal effect of financial slack on firm value, while also examining the mediating roles of corporate reputation and financial performance. The design is grounded in the resource-based view (RBV) and stakeholder theory, which together explain how slack resources can be transformed into competitive advantage and market value when aligned with stakeholder expectations.

2.2 Population and Sample

The study population consists of all non-financial companies listed on the Indonesia Stock Exchange (IDX) for the period 2021–2023. Non-financial firms were selected because financial institutions operate under specific regulatory frameworks that influence their capital structures and reporting standards, which could bias the measurement of financial slack and firm value.

2.3 Data Types and Sources

The study relies on secondary data, collected from multiple sources:

Financial data: extracted from annual reports and audited financial statements available on the IDX official website (www.idx.co.id).

1. Market data: stock prices and market capitalization from IDX to calculate Tobin's Q.
2. Corporate reputation data: drawn from the Corporate Image Index (CII), published annually through the Indonesia's Most Admired Companies Award (IMAC Award) by Frontier Consulting Group.

2.4 Variable Measurement

Independent Variable: Financial Slack (FS). Measured as the natural logarithm of free cash flow, following Bukit & Iskandar (2009). Free cash flow reflects the firm's available financial resources beyond operating and capital needs.

Mediating Variable 1: Corporate Reputation (REP). Measured using the Corporate Image Index (CII). The index is based on stakeholder surveys covering management (40%), investors/shareholders (30%), journalists (20%), and the public (10%). Higher scores denote a stronger reputation.

Mediating Variable 2: Financial Performance (FP). Measured using Return on Assets (ROA) and Return on Equity (ROE), which capture profitability and efficiency in resource utilization.

Dependent Variable: Firm Value (FV). Measured using Tobin's Q, calculated as the ratio of the market value of equity plus total liabilities to total assets. A Tobin's Q above 1 signals that the market values the company more than its recorded assets, indicating strong growth prospects.

3. Results and Discussion

3.1. Descriptive Statistics

Table 1 summarizes the descriptive statistics for all research variables.

Table 1. Descriptive Statistics

Variable	N	Minimum	Maximum	Mean	Std. Deviatio

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					n
Financial Slack (FS)	143	8.23	14.57	11.21	1.62
Reputation (REP)	143	0.85	3.60	2.41	0.71
ROA (%)	143	-5.12	21.34	7.42	4.88
ROE (%)	143	-12.25	36.80	12.19	6.45
Firm Value (Tobin's Q)	143	0.72	3.85	1.87	0.64

Firms in the sample display considerable variation in slack, profitability, and reputation, reflecting different strategic capabilities and market perceptions.

3.2. Classical Assumption Tests

To ensure model validity, several diagnostic tests were conducted.

Table 2. Normality Test Results

Variable	Kolmogorov-Smirnov Sig.	Result
Residual	0.213	Normal

Residuals are normally distributed (Sig. > 0.05).

Table 3. Multicollinearity Test

Variable	Tolerance	VIF	Result
Financial Slack (FS)	0.691	1.45	No problem
Reputation (REP)	0.754	1.33	No problem
ROA	0.723	1.38	No problem
ROE	0.742	1.35	No problem

No multicollinearity detected (VIF < 10).

Table 4. Autocorrelation Test (Durbin-Watson)

Model	DW Value	Result
Main	1.92	No autocorrelation

Table 5. Heteroscedasticity Test (Glejser)

Variable	Sig.	Result
Financial Slack (FS)	0.284	Homoscedasticity
Reputation (REP)	0.331	Homoscedasticity
ROA	0.472	Homoscedasticity
ROE	0.521	Homoscedasticity

3.3. Regression and Path Analysis

The regression models were tested simultaneously and partially.

Table 6. F-Test (Simultaneous Test)

Model	F Value	Sig.	Result
Main	27.16	0.000	Significant ($p < 0.05$)

The independent variables jointly influence firm value.

Table 7. Coefficient of Determination (R^2)

Model	R^2	Adjusted R^2	Interpretation
Main	0.524	0.511	52.4% variation in firm value explained

More than half of the firm value variation is explained by slack, reputation, and performance.

Table 8. Path Coefficients (Direct Effects)

Path	Std. Coefficient	t-Statistic	Sig.	Result
FS → Reputation	0.372	4.95	0.000	Significant
FS → Financial Performance	0.415	5.22	0.000	Significant
Reputation → Firm Value	0.289	3.74	0.000	Significant
Financial Performance → Firm Value	0.441	6.18	0.000	Significant
FS → Firm Value	0.112	1.88	0.062	Weak/Insignif

Slack's direct effect on firm value is weak, but its indirect pathways are strong.

4.4 Mediation Effects

Table 9. Direct, Indirect, and Total Effects

Relationship	Direct Effect	Indirect Effect	Total Effect	Result
FS → Reputation → FV	0.112	0.107	0.219	Partial Med.
FS → Performance → FV	0.112	0.182	0.294	Partial Med.

Table 10. Sobel Test Results

*Corresponding Author: **Marselinus Asri.**

Mediation Path	Z-Value	Sig.	Result
FS → Reputation → FV	2.76	0.006	Significant
FS → Performance → FV	3.42	0.001	Significant

Both mediators are significant, with financial performance showing stronger mediation.

4. Discussion

The findings of this study provide important insights into how financial slack influences firm value, particularly through the mediating roles of corporate reputation and financial performance. While the direct relationship between financial slack and firm value appears weak, the evidence shows that the indirect pathways through reputation and performance are both significant. This highlights that Slack, when strategically managed, can become a valuable resource that enhances market valuation.

From a theoretical perspective, the results are consistent with the resource-based view (RBV). Financial slack alone does not guarantee competitive advantage; rather, its value emerges when it is transformed into resources and capabilities that are valuable, rare, and inimitable. The findings show that Slack enables firms to invest in reputation-building activities such as corporate social responsibility, innovation, and stakeholder engagement, which enhance intangible assets. At the same time, Slack contributes to financial performance by supporting operational efficiency and profitability (Andersén, 2021; Che & Wang, 2022). Both channels ultimately improve firm value, confirming RBV's emphasis on the strategic utilization of resources.

The results also support stakeholder theory, which argues that firms must maintain legitimacy and meet stakeholder expectations to survive and grow. Corporate reputation, as a stakeholder-driven construct, is shown to significantly mediate the relationship between slack and firm value. This indicates that the market rewards not just financial outcomes, but also stakeholder trust and credibility. Investors appear to value firms that allocate slack towards initiatives that strengthen relationships with employees, customers, and society at large (Chofreh et al., 2014; de Jong et al., 2021; Moreno et al., 2018).

The findings help explain inconsistent results in prior studies. Earlier research often produced mixed evidence on the slack–value relationship, with some reporting positive, negative, or insignificant effects. By incorporating mediators, this study shows that slack is not inherently beneficial or harmful; its impact depends on managerial choices. Firms that deploy Slack effectively create value, while those that misuse or hoard Slack risk inefficiency and agency problems.

From a practical standpoint, the results suggest that managers should avoid treating slack as idle reserves. Instead, slack should be strategically allocated to strengthen reputation and financial performance. For example, investments in transparency, product quality, or employee development can enhance reputation, while capital allocation toward efficiency and innovation can boost profitability. These strategies ensure that slack resources are translated into firm value.

For investors, the findings imply that the presence of financial slack should not be judged in isolation. What matters is how Slack is used. Companies with strong slack positions but poor performance or weak reputations may not generate higher valuations. In contrast, firms that effectively convert slack into improved performance and legitimacy tend to be valued more positively by the market.

From a policy perspective, regulators and capital market authorities can play a role by encouraging more detailed disclosures about slack management. Requiring firms to report how they allocate excess resources, whether for investment, innovation, or stakeholder initiatives, would improve transparency and help reduce information asymmetry in emerging markets.

Overall, this discussion underscores that financial slack is a double-edged sword. It can either enhance or erode firm value depending on managerial decisions and stakeholder perceptions. By situating slack within RBV and stakeholder theory, this study demonstrates that slack becomes strategically valuable when deployed to build capabilities that markets recognize as signals of long-term growth and sustainability.

5. Conclusion, Implication, Limitation, and Acknowledgment

5.1 Conclusion

This study examined the effect of financial slack on firm value, with corporate reputation and financial performance as mediating variables, using a sample of 143 firm-year observations from non-financial companies listed on the Indonesia Stock Exchange during 2021–2023. The findings reveal that financial slack has a positive and significant impact on both reputation and financial performance. In turn, these mediating variables strongly influence firm value, while the direct effect of slack on value is relatively weak. Mediation analysis confirms that both reputation and performance serve as significant pathways through which slack enhances firm value, with financial performance exerting a stronger mediating effect. The study concludes that financial slack does not directly create value; instead, it becomes strategically valuable when transformed into intangible assets and operational efficiency that improve investor perceptions and market valuation.

5.2 Implications

1. Theoretical Implications: The results extend the resource-based view (RBV) by showing that slack resources contribute to competitive advantage only when converted into unique capabilities such as reputation and profitability. The findings also reinforce stakeholder theory, highlighting that meeting stakeholder expectations through improved reputation enhances firm legitimacy and value.

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2. Managerial Implications: Managers should avoid treating slack as idle reserves. Instead, slack must be strategically allocated to initiatives that improve efficiency and strengthen stakeholder trust. By doing so, firms can ensure that slack functions as a source of sustainable value creation rather than inefficiency.
3. Investor Implications: Investors should evaluate not only the presence of slack but also how it is deployed. Firms that channel slack into profitable operations and legitimacy-building initiatives are more likely to deliver long-term value.
4. Policy Implications: Regulators may encourage greater disclosure regarding the management of slack resources, enabling stakeholders to assess whether excess funds are utilized for innovation, sustainability, or stakeholder engagement. Such transparency would reduce information asymmetry and strengthen market confidence.

5.3 Limitations

This study has several limitations. First, the observation period of 2021–2023 is relatively short and may not fully capture the long-term dynamics of slack and value creation. Second, the research sample was limited to non-financial firms, excluding financial institutions that may operate under different slack dynamics. Third, the study only considered corporate reputation and financial performance as mediators. Other variables such as innovation capability, corporate governance, or sustainability performance may also play important roles in linking slack to firm value.

5.4 Future Research

Future studies could extend the observation period to include longer economic cycles and broader contexts. Comparative studies between financial and non-financial firms, as well as across emerging and developed markets, may reveal differences in slack utilization strategies. Further research could also incorporate additional mediators such as R&D intensity, governance practices, or CSR engagement to provide a more comprehensive understanding of the mechanisms linking slack to firm value.

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