CHAPTER I

INTRODUCTION

1.1 Research Background

Every company demands fund either for starting up or for developing a business. Fund is a highly important aspect for supporting the survival of a company. Therefore, the needs of fund that a company has will be unlimited. Due to the situation, in several cases debt might be an alternative that should be accepted. This matter is very natural since it is not only a company but also a state that demands fund by means of debt. Based on the information that has been retrieved from Kompas.com (2018), the rise of debt level that the government of Indonesia has experienced becomes a hot issue prior to the 2019 General Election. The central government has experience 48.00% rise on the debt level (almost two times than the era of the previous government) since President JokoWidodo ran the presidency in 2014. The additional debt that the government has been pursuing since 2015 is allocated more to the funding of productive activities such as infrastructure project, welfare fund, and equalization elements.

In running a business, the small-companies up to the large-scale companies certainly have debts as part of their additional capital and funding source for the sake of their survival. Debt is the responsibility of a company that has been incurred by a past transaction and has to be settled by means of cash, goods, and service in the future (Jusuf, 2001). The reason why companies tend to choose for debts than sales of securities is that debts have lower cost but in exchange companies should provide the return to lenders. The fund that lenders have provided for the companies will incur certain cost known as the cost of debt. Cost of debt refers to the level of return prior to tax that should be paid to the lender (Nurauliawati, 2010). Cost of debt might also be defined as the effective rate that a company should pay within the debt that the company has from the other financial institutions or sources. The debt in this case might refer to obligation, loan, and alike. Then, the company should calculate the cost of debt before and after the application of tax. Since the payment of debt interest usually decreases the tax amount, a company usually relies on the cost of debt after tax. Furthermore, the cost of debt is usually intended to define the best interest rate for funding the company. The cost of debt itself might also be used for measuring the company risk because a company that has high risk suffered from high cost of debt.

In such debt system, there are several criteria that should be meet in order that the creditors might be provided with the debt. According to (Huq, 2016) these criteria are known as 5C. The five C's of credit is a system used by lenders to gauge the creditworthiness of potential borrowers. The system weighs five characteristics of the borrower and conditions of the loan, attempting to estimate the chance of default.The five C’s of credit are character, capacity, capital, collateral and conditions. Each of the C’s may have different measures. For example, character can be measure by credit rating and credit history. Capital structure (i. e. a lower debt-equity ratio) is the measurement to understand healthy capital position. Capacity, on the other hand, indicates the ability to repay debts and can be measured by debt-to-income ratio (DTI), earnings amount and stability. Conditions are an overall evaluation of the economic conditions and market segments in which the borrowers operate (Investopedia, 2015). Collateral is often used to complement the capacity of the borrower and acts as a lien in the case borrower fails to repay the debt.

Most of the information that lenders need for assessing the criteria of the creditors can be found on the financial report. For most of the lenders, the information of profit that has been found in a financial report is important in order to identify the quality of the profit and the sufficiency of the company's debt. The profit that has been found on the financial report might also be used for evaluating the performance of the management, predicting the earnings power, and predicting the future earnings (Siallagan and Machfoedz, 2006). The important information on the profit within the decision-making process has resulted in multiple studies with regards to the profit quality. Gagaring (2012) uncover that profit is said to be qualified if the profit becomes the good indicator for the future earnings or has strong relationship to the future operational cash flow. Both the creditors and the lenders do not expect the information of low-quality because the low quality might be a signal for the poor resource allocation. This means that the profit might be one of the criteria for the lenders in granting the debt to the creditors.

The well-qualified profit is assessed based on the condition of stable profit or even increasing profit over the time. If the profit is not stable or fluctuative then the profit will imply the condition of a bad company. Certainly, such condition will influence the assessment of both the lenders and the investors over the company. The low volatility in the profit displays a positive aspect and increase the reliability of the financial report (Cohen, 2013).

Based on the characteristics that have been explained previously, the objective of the present study is to expand the knowledge on the topic by identifying whether the lenders turn the earnings volatility to check the capacity of the company in returning the loan and in defining the interest rate. Earnings volatility is a proxy that has been used for measuring the Earning Quality (EQ) (Huq, 2016). This research use three control variable. They are profitability, liquidity and solvency of the company. Based on the results of the previous studies, it is found that the studies related to Earning Volatility (EV) and Cost of Debt (COD) have been very limited. Hence this paper will make significant contribution to the literature to understand how relevant is EV for borrowers cost of debt. According to the research background explained above and the limited of previous research bring new curiosity to conduct new research with title "**Effect of Earnings Volatility on Cost of Debt"** (studies all companies listed in Indonesia Stock Exchange in period 2012-2016).

1.2 Research Problem

Every business has several main sources of funding, both for start-up or as well for the development and operations of the company. Sources of capital or fund is vary, some are from the result of collaboration with partners, capital from investors and through credit or debt. Debt can be obtained from a financing institution or by issuing a letter of acknowledgment of debt (bonds). The cost of debt originating from a loan is the interest that must be paid by the company, while the cost of debt by issuing a bond is the rate of return of the desired result (required of return) that is expected by the investor to be used as a discount rate in finding the value of the bond. There are three main things that lender (creditor and investor) consider in determining the interest rate or cost of debt to borrowers such as profitability, liquidity and solvency. But behind of that, of course there are other factors that can show the feasibility of borrowers which can be seen from the company's capacity to run its business. The strength of the company in running its business can be seen from the profits earned. Does the borrower's profit or earnings have good and stable prospects or not. If the earnings of a company doesn't stable enough, do lenders consider it to be the factor that can effect determination of interest rate for the borrower ? And also if the company have good and stable earnings, wheter this condition will affect company's cost of debt ? This problem lead to the research question, Is there any effect of earnings volatility on cost of debt.

1.3 Research Objectives

This research aim to investigate the effect of earnings volatility (EV) on cost of debt and the significant difference between association of earnings volatility (EV) with cost of debt for different industries.

1.4 Research Contribution

Hopefully this research could give more benefit in developing knowledge and for the need of related parties, by learning how the effect of earnings volatility on cost of debt in Indonesia.

1. Theoretical Contribution

   This research is contributed to academicians. Hopefully this research can give more knowledge about earnings volatility on cost of debt. The result can give more understanding about the relation for both of them especially in Indonesia. This research can be used as a reference and the source of information for the other research that related to earnings volatility on cost of debt.

2. Practical Contributions

   a. For the Company

   This research can be a motivation for the company to keep maintain the quality of its earnings to remain stable and increase, so they do not need to take some debt and bear the cost of debt. Hence the company will get a good earning rating from the lenders and investors.

   b. For the Investors

   Investors can have insight that there is one aspect of earning need to be considerated besides the common factors and characteristics in making investment decision. Investors could put the earning's quality to assess and predict the company's earnings in the future to get a better dividend.

c. For Creditors

The results of this study will provide more characteristics that creditors can use to assess the borrower's credit worthiness for the borrowing company.

1.5 Writing Structure

CHAPTER I **INTRODUCTION**

Chapter I is an introduction in the preparation of the research which consists of background, research problem, research objectives, research contribution and writing structure.

CHAPTER II **LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT**

Chapter II contains as theoritical framework and previous literature review used to support the critical thinking and used as references to construct the framework and hypothesis development.

CHAPTER III **RESEARCH METHOD**

Chapter III contains of data related to the research, it includes population and sample, sample criteria, data collection method, measurement variable, data analysis techniques, and hypothesis testing method.

CHAPTER IV **DATA ANALYSIS AND DISCUSSION**

Chapter IV contains the result and discussion of the research by observing the data processing result and analysis. This chapter provides information whether the hypothesis meet the criteria, accepted or rejected.

CHAPTER V **CONCLUSION**

Chapter V contains conclusion of the research, limitation and suggestion for future research.