CHAPTER I

INTRODUCTION

1.1 Research Background

Stocks are the most common and actively traded securities in financial markets, it is regarded as a long-term source of funding (Thomas Arkan, 2016). Stocks give the holders the right to receive profit in the case of an entity to achieve profits or bear the loss as much as their shares. It gives the right to own part of a company and entitles this right of management both through its membership in the general assembly of shareholders or by the Board of Directors.

Capital market research on fundamental analysis has become extremely popular in recent years, in part because of mounting evidence in the financial economics literature against the efficient markets' hypothesis (Kothari, 2001). Studies that employ fundamental analysis to forecast earnings and future stock returns (i.e., a test of market efficiency) include Ou and Penman (1989a; 1989b), Holthausen and Larcker (1992), Hadi *et al.* (2016), Malik, Lev, and Thiagarajan (1993) and Abarbanell and Bushee (1997; 1998). Fundamental analysis involves the use of current and past financial statements in conjunction with industry and economic data in order to determine firms' intrinsic value and identify mispriced securities (Seng, 2012).

Financial statements show financial condition of a company. It is as the result of the company's operation to provide financial information that has benefits for the entities both inside and outside company such as investors, creditors, and government. From the perspective of information economics, accounting and financial reporting play a vital role in an efficient capital market.

One of the most common ways of assessing the relative values of stocks among practitioners is to compare the numbers listed in financial statements by using financial ratios. The main advantage of using financial ratios instead of amounts from the income statement is that they are independent of the size of the company. The comparison of financial ratios is used to assess companies' financial condition, operations, and attractiveness as an investment.

Debt-to-equity ratio is used by analyst as a measure of capital structure (Investopedia, 2018). This conventional external source of funding businesses can generally be classified under two broad headings, debt and equity (which are commonly called as ordinary capital). In most of the cases, it is a combination of the two. Capital structure, or what is generally known as capital mix, is very important to control the overall cost of capital in order to improve the earnings per share of shareholders. It is one of the important determinants of a firm's success. Initially, the company has to plan its capital structure at the time of its promotion. Subsequently, whenever funds have to be raised for finance and investment, a capital structure decision is involved.

Debt refers to borrowings made by the business from outsiders who are paid a periodic interest on the money rendered. Lenders do not have participation rights but are given priority as to the repayment of interest and principal. Their money is secured by creating a charge on the business assets. A charge on asset means that in the event of default, debt providers can sell company's assets to recover their dues. While this reduces the risk element for the investor, it creates an extra burden on the company to generate sufficient profits to be able to meet the debt obligations on time. Since debt providers are outsiders, the payment of interest on debt is treated as a tax-deductible business expense.

Equity refers to a right to participate in the business and equity holders are considered as owners of the business. It is more expensive than debt, especially when interest rates are low. However, unlike debt, equity does not need to be paid back if earnings decline. On the other hand, equity represents a claim on the future earnings of the company as an owner. Since equity is right of ownership, distribution of profits to equity holders is not a tax-deductible expense.

Modigliani-Miller (1958) demonstrates that when production-investment decisions are held fixed, the value of a firm is invariant to the composition of its capital structure given a perfect capital market (frictionless and perfectly competitive) and no taxes. Stephen Ross in 1977 develops a model where capital structure serves as a signal of private information of corporate insiders, attack the MM-assumption. In accordance with the

Signaling model by Ross, an increase in gearing presents, in term of the company's prospective cash flows, a positive signal to external investors. In Ross' model the capital market interprets debt issues of managers with insider information as a valid signal of higher quality leading to an increase in the value of the firm.

Pandey (2004) argued that capital structure decision should be analyzed to examine its effect on the value of the firm. De Wet (2006) studied the relationship between firm value and optimal gearing level. Ramachandran and Candasamy (2011) proved that a strong one-to-one relationship exists between capital structure and profitability variables, where capital structure has a significant influence on the profitability of the firm. Goyal (2013) revealed a positive relationship of debt with profitability.

The financial ratio analysis has been developed over many years and it has become more than a tool of evaluation. The wide use of this ratio is growing because it is easy to calculate financial ratios, and for being a quantitative measure to judge the internal units, also the financial ratios provide basic indicators for judging performance without the need to provide some financial details.

The use of accounting data and financial ratios to explain changes in stock prices is frequently referred to in the literature. Using a financial ratio analysis can be largely attributed to changes in stock price has often been discussed by academics and financial analysts.

Kendall (1953) observes that stock prices seem to change randomly over time, and he tested whether a previous price could be used to predict a future price change. Ball and Brown (1968) originally researched the correlation between accounting information and stock price. They found that if a company had excess earnings and then investors could get an abnormal return. Bernard and Stober, Dechow (1994) and Sloan (1996) respectively empirically studied the influence of earnings information and operating cash flow information on stock price, founding a correlative among them rather than absolute.

1.2 Problem Identification

Researcher ever found 2 companies (in the same industry) have different capital structure and financial ratios. One has valued higher than the other while this lower-stock-price company has a good financial performance compared to the higher one. Based on the previous explanation and previous study, then this research wants to find whether the stock price is affected by capital structure and financial ratios, under formulation as follows:

1. Does capital structure have positive significant relationship to stock price?

2. Do financial ratios have positive significant relationship to stock price?

1.3 Research Objectives

This research conducted to know the effect of capital structure and financial ratios on stock price in trade, service, and investment sector in Indonesia Stock Exchange under the following descriptions:

1. To find the empirical evidence about the positive significant relationship between capital structure and stock price.

2. To find the empirical evidence about the positive significant relationship between financial ratios and stock price.

1.4 Research Contributions

This research expected to contribute in several aspects based on background, problem statement and research objectives for:

1. Academic Value

   The result of this research expected to give the contribution in the development of economics science, especially in financial accounting. Moreover, by this research it would make the diversity of science for those who want to hold next research.

2. External Parties

   The result of this research expected to give contributions in theory, relating to the effect of capital structure and financial ratios toward stock price disclosure in Indonesia. The parties who are expected: (1) Investors and stakeholders, that can be an additional information to

analyze the corporation because those parties should be cautious and have a deep fundamental analysis in order to decide which corporation to invest to; (2) Other parties, that can give information as knowledge to know about which ratio can be used to value the company.

1.5 Research Structure

In this research, there will be 6 chapters consist of:

CHAPTER 1   INTRODUCTION

Consist of background of the research, problem statement, research objectives, research contribution and the structure of the research.

CHAPTER 2   LITERATURE REVIEW

Consist of explanation of definition and previous research.

CHAPTER 3   HYPOTHESES

Consist of hypotheses and conceptual framework.

CHAPTER 4   RESEARCH METHODOLOGY

Consist of research design, type and source of data, explanation about population, sample and technique of sampling; unit analysis, definition operationalization variable and analysis technique data.

CHAPTER 5   DATA ANALYSIS AND DISCUSSION

Consist of the explanation of data analysis and result discussion.

CHAPTER 6   CONCLUSION

Consist of the conclusion, limitation and advice of the research & the next research.