CHAPTER II

THEORITICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

2.1 Literature Background

This part will showing about some theory as the basic for this research. This topic useful for solving the main problem on this research. This topic involves conceptual framework, the functions of financial report and its characteristics, financing activities, investor perspectives, capital structure, firm value, and previous research.

2.1.1 The Role of Conceptual Framework

The conceptual framework for financial reporting describes the objective of and the concepts for general purpose of financial reporting. The purpose of the conceptual framework is to assist the IASB to develop IFRS (standards) that are based on consistent concepts; assist preparers to develop consistent accounting policies when no standard applies to a particular transaction or other event, or when a standard allows a choice of accounting policy; and assist all parties to understand and interpret the standards. The conceptual framework may be revised from time to time on the basis of the IASB's experience of working with it. Revisions of the conceptual framework will not automatically lead to changes to the standards. Any decision to amend a standard would require the IASB to go through its due process for adding a project to its agenda and developing an amendment to that standard.

The conceptual framework contributes to the stated mission of the IASB. That mission is to develop standards that bring transparency, accountability and efficiency to financial markets around the world. The IASB's work serves the public interest by fostering trust, growth and long term financial stability in the global economy. The conceptual framework provides the foundation for standards that:

1. Contribute to transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions.
2. Strengthen accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money. Standards based on the conceptual framework provide information needed to hold management to account. As a source of globally comparable information, those standards are also of vital importance to regulators.
3. Contribute to economic efficiency by helping investors to identify opportunities and risks across the world, thus improving capital allocation. For businesses, the use of a single, trusted accounting language derived from standards based on the conceptual framework lowers the cost of capital and reduces international reporting costs.

Accounting standard should be in line with conceptual framework. When accounting standard is consistent with the conceptual framework, the standard will be useful for user including the financial report itself. Accounting conceptual framework can be described as a coherent systems of concept, which are guidelines to the accounting standards used for financial reporting. Accounting conceptual

framework outlines the concept about conceptual framework for financial reporting which issued by the IASB in 2010 as a result of a joint project between IASB and the United States Financial Accounting Standards Board (FASB). The conceptual framework contains sections from the existing framework to the preparation and presentation of financial statements (known as the framework) issued by the IASB in 1989. The framework had been adopted or used as the basis for the conceptual framework in several countries.

The conceptual framework states that it is concerned with general purpose of financial reports. These can be defined as financial reports intended to meet the needs of users who are not in a position to require an entitiy to prepare reports tailored to their particular information needs. The financial report within an annual report is an example of a general purpose financial report. The conceptual framewok does not need to be applied in the preparation of special purpose financial report, which are reports prepared to meet the needs of particular users. These normally contain specialised information designed for users who have the power to ask for the information they need. For example:

1. Some lenders can require, as part of the terms for granting a loan, that reports be prepared with spesific information
2. Taxation authorities can require spesific reports
3. Management could require, and be able to obtain more detailed reports.

It is important to consider who the users are and what information they need, given that the purpose of financial report is to provide them with useful information.

The conceptual framework identifies a limited range of primary users of financial statement. They include existing and potential investors, lenders, other creditors. Compared to the framework, which in addition to those listed above also included customers, employees, governments and their agencies and the public, this is a fairly limited set of users focused on those who provide financial resources to the entity. The conceptual framework accepts that financial report may also be useful to others, but explicitly confirms that the information included is directed at the primary user groups and not alternative groups. The primacy of the investor is a common position taken in many of the accounting conceptual framework and reflects that historically these framework have been developed in countries where capital markets and the related protection of investors have been key influences on accounting developments and regulation. However the conceptual framework does not differentiate between the relative importance of those resource providers identified as the primary users.

Even with this restricted range of users, the conceptual framework acknowledges that not all their information needs can be met by general purpose financial statements. The aims is to provide information where users needs overlap or are shared- that is to meet the information needs that are common to these user groups and meet the needs of the maximum number of these primary users. The information in financial reports is limited mainly to financial information. This is normally in the form of a statement of financial position, a statement of profit or loss and other comprehensive income, a statement of cash flow, a statement of changes in equity and associated notes. The conceptual framework explicitly states that these reports are not designed to show the value of a reporting entity. The financial report

provide financial information about the past transactions and events of the entity. As noted, users will also need information about the future to help them make their decision. Therefore in financial report which mainly report about financial has to consider about four standard contents which are:

1. Balance sheet which shows the entity's assets, liabilities, and stockholders's equity as of the report date. It does not show information that covers a span of time.
2. Income statement which shows the results of the entity's operations and financial activities for the reporting period. It includes revenues, expenses, gains, and losses.
3. Statement of cash flows which shows changes in the entity's cash flows during the reporting period.
4. Supplementary notes includes explanations of various activities, additional detail on some accounts, and other items as mandated by the applicable accounting framework, such as GAAP or IFRS.

The financial report that report about these 4 standard contents should complied with the objective of financial report for the users in order the report can be really useful and fulfill the user needs.

2.1.1.1 The Objective of Financial Report

Conceptual framework states that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful

to existing and potential investors, lenders and other creditors in making decision about providing resources to the entity. Those decisions involve decisions about:

1. buying, selling or holding equity and debt instruments;
2. providing or settling loans and other forms of credit; or
3. exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

The decisions depends on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases. The expectations of investors, lenders and other creditors about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Existing and potential investors, lenders and other creditors need information to help them make those assessments. To make the assessments, existing and potential investors, lenders and other creditors need information about the economic resources of the entity, claims against the entity and changes in those resources and claims and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources. According to conceptual framework, there are broadly two views of what should be the objective of financial reporting, those are:

1. Stewardship or accountability
2. Decision usefulness.

Stewardship or accountability focuses on the duty of the managers of an entity. They are entrusted with the resources of the entity. Stewardship or accountability requires the managers to provide a report to the providers of the resources to explain how well they have managed them. Historically this was the main purpose of financial report and accounting. Given the separation of managers and owners (such as shareholders), ensuring that managers provided an account of their activities and how they managed the resource entrusted to them was considered the primary reason for financial report. Under this objective, the financial report should provide information that is useful to users in making decision. This requiring considering how information is used in decision making. In models of decision process, information is needed to:

1. Help us predict what may happen in the future. This doesn't mean, however that financial statement necessarily provide forecasted or future oriented information. However the information provided should make the user predictions.
2. Provide feedback on previous decisions. Information can help in deciding whether past decision, and information used to make them, were correct and can help in making better decision in the future.

It is also assumed financial report that provide information useful for decision making will also provide the information needed to assess accountability. As the conceptual framework states: Information about management's discharge of its responsibilities is also useful for decision by existing investor, lenders, and other

creditors who have the right to vote on or otherwise influence on management's action.

The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources. In achieving the objective of financial report which are predict the condition in the future and make a decision, every financial report should complied with fundamental qualitative characteristics and enhacing qualitative characteristics.

2.1.1.2 Fundamental Qualitative Characteristics of Financial Report

Financial report should useful for decision making (and therefore appropriate to consider for inclusion in the financial report), information in financial report must have both of the two fundamental characteristics. Those are:

1. Relevance

   The relevance characteristics aims to ensure that only financial information that could make a difference in decision is included. This fundamental qualitative characteristics outline why the financial information is needed. It is linked directly to the purpose of financial report which is to provide useful information to users in making decision. Clearly if the information can not be used either to help make prediction or to provide feedback, it is not useful to users, so would not be relevant and should not be included in the financial

report. For these reasons, relevance is often the first 'test' applied to financial information although as noted later the other fundamental qualitative characteristic of faithful representation must also be met.

A related aspect of relevance is materiality. This is the quality of information of its omission or misstatement could influence the economic decision of users taken on the basis of the financial report. As users decision are made in the context of a spesific reporting entity the conceptual framework notes that materiality is entity spesific. In other words, the same information may be relevant for users of one entity but not another.

2. Faithful Representation

The purpose of faithful representation is to make sure that users have confidence in and can trust the financial information that is provided in financial reports. Faithful representations requires making sure that what is shown in the financial reports corresponds to the actual events and transactions that are being represented. Accounting standards often requires us to consider the substance over from that is requiring items to be accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

There are also enhancing qualitative characteristics consist of comparability, verifiability, timeliness and understandability. Enhance qualitative characteristics are qualitative characteristics that enhance the usefulness of information that both is relevant and provides a faithful representation of what it purports to represent. The enhancing qualitative characteristics may also help determine which of two ways

should be used to depict a phenomenon if both are considered to provide equally relevant information and an equally faithful representation of that phenomenon.

1. Comparability

   Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item. A comparison requires at least two items.

2. Verifiability

   Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.

3. Timeliness

   Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

4. Understandability

   Classifying, characterising and presenting information clearly and concisely makes it understandable. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore possibly misleading. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

5. Complete depiction

   Users require all relevant information about an event or phenomena to be included in the financial report, if these are to be useful for decision making. Good decision can not be made on the basis of incomplete information.

6. Neutrality

   For information to be neutral, it must be free from bias. This component of faithful representation aims to ensure that there is no attempt to promote any particular view and that the financial reports provide an important description of the events and transaction.

7. Freedom from error

   Clearly if there are errors in the information it is not a faithful representation. This does not imply however that the information is exact. Many estimates are used in accounting and in hidnsight many of these will be found to be incorrect or inaccurate. Providing these estimates are identified as such, and made on a reasonable basis, these would still meet the requirement for faithful representation.

Financial report should provide information based on the fundamental qualitative characteristics and enhancing qualitative characteristics which can be usefull for user such as investor in making decision and make assessment whether they will invest on that company or not. This information is really important for them and can affect user perspectives including investor.

2.1.2 Investors/ Shareholders Perspective

Investor as the user of financial report really consider fully about financial information including the price of company's stock. Stock prices reflects investors perception about the firm. Investors hold stocks because they expect to obtain dividends and/or make capital gains. When investors expect future profits to be high, they pay more to hold the stock; when investors expect profits to be low, they pay less. Investors do not know what future profits will be, but they can collect pieces of information that may help them assess the firm's value. For example, investors can look at the firm's financial statements as well as the financial statements of other firms in the same industry to compare the performace of those company. This

information is used to give a feedback for shareholders and other user as one of the objective of financial report which is accountability of manager as the agent in managing the company to meet the interest of real owners (shareholders). Through the financial report, the investor or shareholders also can see the financial condition of company that they will invested on such as financing activities of the company.

2.1.3 Financing Activities

Financial report as the source of information for shareholders and other users can contain a lot of information about the entity itself and one of that information is about financing activities. One part of financial report which is *statement of cash flows which* shows changes in the entity's cash flows during the reporting period which shows about the financing activities as a section of a company’s cash flow statement, it shows the net flows of cash that are used to fund the company. Financing activities include transactions involving debt, equity, and dividends. Cash flow from financing activities provides investors with insight into a company’s financial strength and how well a company's capital structure is managed.

The cash flow statement is one of the three main financial statements that shows the state of a company's financial health, the other two being the balance sheet and income statement. The cash flow statement measures the cash generated or used by a company during a given period. The cash flow statement has three sections: cash flow from operating (CFO), cash flow from investing (CFI), and cash flow from financing activities (CFF). Cash flow from financing activities measures the movement of cash between a firm and its owners, investors, and creditors. It

indicates the means by which a company raises cash to maintain or grow its operations. A company's source of capital can be raised from either debt or equity. When a company takes on debt, it typically does so by either issuing bonds or taking a loan from the bank. Either way, it must make interest payments to its bondholders and creditors to compensate them for loaning their money. When a company goes through the equity route, it issues stock to investors who purchase the stock for a share in the company. Some companies make dividend payments to shareholders, which represents a cost of equity for the firm. Debt and equity financing are reflected in the cash flow from financing section, which varies with the different capital structures, dividend policies, or debt terms that companies may have.

Financing activities are transactions or business events that affect liabilities and equity. In other words, financing activities are transactions with creditors or investors used to fund either company operations or expansions. These transactions are the third set of cash activities displayed on the statement of cash flows. Financing activities show how a company funds its operations and expansions externally. Both investors and creditors are interested to see how efficiently a business can use its existing cash to fund operations and how effectively it can raise capital for upcoming projects. In a way, the financing activities section of the cash flow statement indicates how liquid a company is. Items that may be included in the financing activities line are: Sale of stock (positive cash flow), Repurchase of company stock (negative cash flow), Issuance of debt, such as bonds (positive cash flow), Repayment of debt (negative cash flow), Payment of dividends (negative cash flow), Donor contributions restricted to long-term use (positive

cash flow). As company try to fund the company operation and expansion through issued stock, each investor has their own perception about company's stock price whether it is to high or low price. This consideration (stock price) would be one factor whether the investor would buy/ invest on that company or not. When company trying to fund the company's operation, they can obtain or raise the fund or the capital through debt and equity. This choice is based on company's consideration related with the advantages and disadvantages for each whether by issuing bond and borrowing on creditors (debt) or issuing shares on capital market (equity). The way company raise capital whether from debt or equity will be showing in company's capital structure.

2.1.4 Capital Structure

2.1.4.1 Component of Capital Structure

Capital structure is the mixture composition between debt and equity as a source of capital. Debt financing is generally considered to be an inexpensive source of capital for business, as the cost of debt is tax deductible, especially when compared to equity, which also involves giving up part of the ownership of the company. Debt financing can be short term or long term in nature. Long term debt financing, as the scheduled repayment of the loan and the estimated useful life of the assets extends over more than one year.

Short term debt financing is sought to fund the day to day operations of the business, such as purchasing inventory, supplies, or paying the wages of employees. Short term debt financing is referred to as an operating loan or short term loan

because the schedule repayment takes place in less than one year. There are several advantages of raising capital through debt such as:

1. Retain maximum control over business as debt does not dilute the owner's ownership interest in the company
2. The interest on debt financing is tax deductible
3. The lenders/ providers of debt do not share in profits
4. The managerial decision are shared neither with the creditors nor with the debt holders
5. Raising debt capital is more economical
6. Except in the case of variable rate loans, principal and interest obligations are known amounts which can be forecasted and planned for
7. The company is not required to hold periodic meetings of lenders and seek the vote of debt holders before taking certain actions

Besides those advantages, there are also several disadvantages of raising capital through debt. The disadvantages should be a consideration for every company when they need to fund their operation using debt, the disadvantages are:

1. Unlike equity, debt must at some point be repaid
2. The larger a company's debt-equity ratio, the more risky the company is considered by lenders and investor. Accordingly, the amount of debt a business can carry is linked to equity levels
3. Too much debt liabilities can spoil the credit rating of the organization

4. Debt instruments often contain restricitions on the company’s activities, preventing management from pursuing alternative financing options and non core busines opportunities.
5. The company is usually required to pledge assets of the company to the lenders as collateral, and owners of the company are in some cases required to personally guarantee repayment of the loan.

The other component of capital is equity financing in which raising capital by issuing shares in capital market. Stock typically takes the form of shares of either common stock or preferred stock. As a unit of ownership, common stock typically carries voting rights that can be exercised in corporate decisions. Preferred stock differs from common stock in that it does not carry voting rights but is legally entitled to receive a certain level of dividend payments before any dividends can be issued to other shareholders. Convertible preferred stock is preferred stock that includes an option for the holder to convert the preferred shares into a fixed number of common shares, usually anytime after a predetermined date. There are several advantages of raising capital through issuing shares such as:

1. Increased public awareness of the company because IPOs often geberate publicity by making their product known to a new group of potential customers
2. Equity capital need not be repaid, unless a company is liquidated and can perpetually be used to grow the business

Besides those advantages, there are also several disadvantages of raising capital through issuing shares. This advantages should be a consideration for every company when they need to fund their operation using equity, the disadvantages are:

1. Raising equity finance is demanding, costly and time consuming
2. Depending on the investor profile, one will lose a certain amount of power to make management decisions

2.1.4.2 Bankruptcy Cost

One limit to the amount of debt a firm might use comes in the form of bankruptcy costs. As the debt to equity ratio rises, so too does the probability that the firm could be unable to pay its bondholders what was promised to them. When this happens, ownership of the firm's assets is ultimately transferred from the shareholders to the bondholders. In principle, a firm is bankrupt when the value of its assets equals the value of the debt. When this occurs, the value of equity is zero and the shareholders turn over control of the firm to the bondholders. When this takes place, the bondholders hold assets whose value is exactly equal to what is owed on the debt. When a firm is having significant problems in meeting its debt obligations, we say it is experiencing financial distress. The consequences of using debt is the possibility of financial distress or financial difficulties, which can be defined in several ways:

1. Business failure. Although this term usually refers to a situation where a business has terminated with a loss to creditors, even an all-equity firm can fail.

2. Legal bankruptcy. Firms bring petitions to a federal court for bankruptcy. Bankruptcy is a legal proceeding for liquidating or reorganizing a business.

3. Technical insolvency. Technical insolvency occurs when a firm defaults on a current legal obligation; for example, it does not pay a bill. Technical insolvency is a short-term condition that may be reversed to avoid bankruptcy.

4. Accounting insolvency. Firms with negative net worth are insolvent on the books. This happens when the total book liabilities exceed the book value of the total assets.

2.1.4.3 Theories for Capital Structure

2.1.4.3.1 Modigliani dan Miller (MM) Theory

The modern theory of capital structure began with the celebrated paper of Modigliani and Miller (1958). They pointed the direction that such theories must take by showing under what conditions capital structure is irrelevant. Franco Modigliani and Merton Miller (MM) introduced a theory of capital structure theory mathematically, scientifically and on the basis of continuous research. Franco Modigliani and Merton Miller (MM) introduces capital structure theory with the following assumptions: 1) no tax. 2) investors can borrow at the same level as the company. 3) information is always available to all investors and can be obtained at no cost. 4) EBIT does not affect debt use. MM theory suggests that with the assumption of perfect capital market, the capital structure used by companies does not affect the value of the company. But if there is a tax, the company will use more debt so that the company's value will increase (Modigliani and Miller, 1958).

2.1.4.3.2 Trade Off Theory

According to the trade-off theory expressed by Myers (2001), "Companies will owe up to a certain level of debt, where tax savings (tax shields) from additional debt equals the cost of financial difficulties. The cost of financial difficulties is bankruptcy costs. The trade-off theory in determining the optimal capital structure includes several factors, including taxes and financial distress, but still maintains the assumption of market efficiency and symmetric information in the balance and benefits of using debt. As long as the benefit is higher, additional of debt is still allowed. If the disadvantages of the use of debt is greater, then additional debt is no longer allowed.

2.1.4.3.3 The Pecking Order Theory

This theory briefly explains the funding decisions which stated that companies tend to use internal funding sources (retained earnings) first, namely from retained earnings, rather than using external funds (debt and issued shares) from funding activities. Debt, which is an external funding source, is only used by the company if it does not have sufficient and adequate internal funds and if debt is still not sufficient then will be followed by issuing shares. A key element in the pecking-order theory is that firms prefer to use internal financing whenever possible, and second choices is debt, and third choices is issued shares. A simple reason is that selling securities to raise cash can be expensive, so it makes sense to avoid doing so if possible. If a firm is very profitable, it might never need external financing; so it would end up with little or no debt.

2.1.5 Firm Value

Corporate values is very important for each company because the high value of the company will be recognized by the high prosperity of shareholders. Firm value is defined as perception of investors to the level of success of the company in managing resources that will be showing through the share price (Sujoko and Soebiantoro, 2007). The prosperity of shareholders can be showing through the stock price. The higher the stock price the higher the value of the company and stated by Pandey (2004) that the capital structure decision of a firm influences its shareholders return and risk. The wealth of shareholders is represented by the market price of the stock which is a reflection of investment decisions, financing, and asset management. Firm value can be assessed through several side and according to Yulius and Tarigan (2007), said there are several value concepts that explain the value of a company, namely:

1. Nominal value

Nominal value is a formally stated value in the articles of association of the company, explicitly stated on the company's balance sheet and clearly written in collective share letters.

2. Market Value

Market value is the price that occurs from the process of bargaining on the stock market. This value can only be determined if the company's shares are sold on the stock market.

3. Intrinsic Value

Intrinsic value is the most abstract concept, because it refers to the estimated real value of a company. The value of the company in the concept of intrinsic value is not just the price of a set of assets, but the value of the company as a business entity that has the ability to generate profits later on.

4. Book Value

Book value is the value of a company calculated on the basis of an accounting concept or calculated by dividing the difference between total assets and total debt with the number of shares outstanding.

5. Liquidation Value

The value of liquidation is the selling value of all company assets after deducting all obligations that must be fulfilled. The liquidation value can be calculated in the same way by calculating the book value.

2.1.5.1 Firm Value Measurement

Firm value is measured by the assessment ratio or market ratio. Assessment ratio is the overall financial performance measurement. Some indicators to measure firm value :

1. Price to Earning Ratio (P/E ratio)

   P/E ratio indicates the dollar amount an investor can expect to invest in a company in order to receive one dollar of that company's earnings. P/E is

sometimes referred as the price multiple because it shows how much investors are willing to pay per dollar of earnings. Higher P/E ratio, higher firm possibility to grow and increase its value.

2. Price to Book Value (PBV)

Second measurement of firm value is Price to Book Value (PBV). PBV shows how corporation creates corporate value in terms of price over the existing capital. Higher PBV means corporate success providing satisfaction and prosperity of shareholders. Commonly, PBV result more than 1 means corporate market price higher than its book value. This result will thus rise investors trust to the corporate prospect in the future.

3. Tobin's Q

Tobin's Q is used as a method to assess a firm value. Tobin's Q is first introduced by Kaldor (1966) as the ratio between a physical asset's market value and its replacement value (reproduction cost). In 1968, it was reintroduced by William and Tobin. The letter "Q" did not appear until Tobin published an article titled a general equilibrium approach to monetary theory in the Journal of Money, Credit and Banking in 1969. It is a common method of assessing the fair or equilibrium value of the stock market.

Tobin's Q is defined as the ratio of the market value of a firm divided by the book value of its assets. A firm that creates a market value that is greater than the replacement cost of its assets is perceived as using its resources more effectively and thus as creating increased shareholder value (Lewellen and Badrinath, 1997). The Tobin's Q ratio is a ratio devised by James Tobin of

Yale University, Nobel laureate in economics, who hypothesized that the combined market value of all the companies on the stock market should be about equal to their replacement costs.The value of the firm can be showing through share price. When the share price is higher, the wealth of shareholders will be higher too and converserly the lower the share price means the lower the wealth of shareholders.

2.1.5.2 Factors Affecting Firm's Value

There are several factor who can affect the firm value beside capital structure. The changing of several financial condition will also becomes a consideration for user of financial report especially for shareholders in analysing the prospect future of firm value. Some factors are:

1. Firm Size

Firm size can be defined as the total assets of the company. When the company have lot of assets, they can produce more product or service, besides this asset also can be a guarantee when the company borrowing some money. The more the company have assets, the higher solvability and liquidity of that company.

2. Profitability

Profitability can be defined as the ability of the company to yield income through some policy made by manajer. Profit can affect the firm value through share price. When the company have high profit, it would be more attractive for investor to buy the company's share or invested on that company and then the firm value would be increase.

2.1.6 Previous Research

This research is started from the research of Modigliani and Miller (1958) who in their research concluded that the value of the firm is not determined by capital structure and that the value of an unlevered firm is equal to that of a levered firm. The research was based on the assumption of absence of taxes. This assumption was considered unrealistic and in their subsequent research Modigliani and Miller (1963) took tax into consideration and concluded that because of tax shield on debt as a factor, the value of a levered firm was more than the value of an unlevered firm and this value was equal to the value of the tax shield.

The other research conducted by Elsa Imelda and Sheila Sheila (2017) examined empirically the influence of capital structure, dividend policy, and ownership structure toward firm value with growth opportunity as moderating variable. They used manufacturing industries listed on Indonesia Stock Exchange during 2012-2014 and there are 96 samples are used in this research. The method of analysis was multiple linear regression using Eviews 7 program. The result shows that there is a significant relationship between capital structure and ownership structure with firm value in corporate with high growth opportunity.

The other research about Financial Performance Towards Value of Firms in Basic and Chemicals Industry conducted by P. Purwanto and Jillian Agustin (2017). This research aims to empirically prove the significant influences of financial performance towards value of firm. This research chose the population in basic and chemicals industry listed on Indonesia Stock Exchange during the period of 2009-

2014. The result of this study is there is significant influence of debt to equity ratio towards price to book value in basic industry and chemicals sector. Debt to equity ratio has negative influence towards the price to book value, which is indicated by coefficient regression of -1.028114. It means that an increase in debt to equity ratio will decrease the price to book value.

The other research that conducted in Jakarta Stock Exchange in which now become Indonesia Stock exchange. This research made by Handoyo Wibisono (2008) about the determinant of capital structure and its effects on firm value of 21 companies listed on Jakarta Stock Exchange in period 1990-2006, and this research approved that firm's value is not determined by capital structure decision, because the investors do not respond to any changes on capital structure. It is showed by significant that goes beyond 0,05. Beside that from the equation, the effect of capital structure on firm value is only 0,31% (adjusted R^2 =0,0031), and 99,69% firm value is affected by the other factors out of capital structure.

The other research concducted by Chowdhury and Chowdhury (2010) attempt to empirically investigate the influence of debt-equity ratio on the value of shares given different sizes, industries and growth opportunities with the companies incorporated in Chittagong Stock Exchange (CSE) and Dhaka Stock Exchange (DSE) of Bangladesh. In order provide a comparative analysis and give robustness of the analysis they draw samples from the four most leading sectors of industry including chemical and pharmaceutical engineering, fuel and power, and food and allied. Their empirical findings show strong positively correlated association between the dependent and independent variables. The analysis section of the paper

is based on published data of 77 non-financial companies listed on the two Stock Exchanges of the country from year 1999 to 2003. The interesting finding of this paper suggests that maximizing the wealth of shareholders requires a perfect combination of debt and equity, whereas cost of capital has a negative correlation in this decision and it has to be as minimum as possible. This is also seen that by changing the capital structure composition a firm can increase its value in the market. Nonetheless, this could be a significant policy implication for finance managers, because they can utilize debt to form optimal capital structure to maximize the wealth of shareholders.

The other study conducted by Sasya Sabrina, Armanto Witjaksono, and Lusianah (2018) about The Most Influential Factors Toward Firm Value (Case Study In Indonesia) provides empirical evidence that financing decision does not affect firm value. Financing decision variable has sig. value of 0.088. The purpose of this research is to investigate the most influential factor among investment decision, financing decision, and dividend policy toward firm value that uses 109 samples from publicly listed manufacturing companies in Indonesia Stock Exchange (Bursa Efek Indonesia) in 2014, 2015, and 2016.

2.2 Hypothesis Development

Capital structure is very important for every company. The way of company finance their whole operation would impact on the value of that company itself that would be expressed through share price. The company can get their own capital through debt by making a loan on creditors and issuing bonds for bondholders or

whether the company need to issue shares on capital market. These two kinds of financing, needed to be consider well by the manager. When the manager relied more on debt, the company can get the high risk such as bankruptcy risk or solvency problem. But in the other side, when the company have higher debt, they can get the tax shield through the addition of interest expense. So the company can decrease their tax legally, and that's what happen on some company as their strategics to decrease the expenditure rather than collecting fund through issuing new shares. For that reason, the financial manager should considerfully about the benefit and the cost of collecting fund from a loan or issuing bond (debt) as their capital resources.

The trade-off theory expressed by Myers (1993) stated that "Companies will owe up to a certain level of debt, where tax savings (tax shields) from additional debt equals to the cost of financial difficulties of debt. This theory showing that if company take more on debt, they will get the benefit which is tax shields because interest of debt can be a tax deductible for company itself, timeless consuming and more easy to collecting the fund compare to issued shres on capital market. This can rise the company's financial as long as the benefit from the debt itself is higher than the financial difficulties of debt. In addition by having more on debt, the good perception from investor will increase because as the company have theirown courage to expand the company operation and through the discipline payment of loan and the interest, the company can show the commitment as the good company. When the company has tax shield, it can decrease the company's expenditure on tax payment. Shareholders and the new investor will see that the company have been more productive and can managing the expenditure effectively, and as we know for

company who has a good financial condition, it would be more attractive for the investor to buy share and invest on that company. Finally when the shareholder want to invest more and new investor buying the company's share, the market price of share would be increasing. The increase of share price would increse the firm value.

Capital structure that one consist of debt as their capital resource could be a good signal for investor that company has a courage to expand the operation as what shareholders (principal) expected. Moreover, when the company can make a discipline payment for the loan to the creditors, it increase the credit rating and the reputation of company itself. For that reason the company need to consider fully how they can raise the capital and manage it efficiently in getting income as much as possible. High income increases the share price that would be impact on the prosperity of shareholders, and because of it investor will attracted to invest on that company and firm value would be increase. Myers (2001) demonstrated that the existence of tax shield from interest expense of debt would cause the value of the firm to rise with the amount of debt financing by the amount of the capitalized value of the tax shield.

This topic is really interesting to be continued especially if applied in manufacturing companies in Indonesia as the huge contributor for Indonesia's GDP and the highest business sector growth company. The author believe that every business sector country has their own preference on a way of collecting fund (financing decision), that would make different result from the previous research such as Modigliani and Miller (1958) who doing the research first about the value of

the firm which concluded that the value of the firm is not determined by capital structure and that the value of an unlevered firm is equal to that of a levered firm.

The other research about Financial Performance Towards Value of Firms in Basic and Chemicals Industry conducted by P. Purwanto and Jillian Agustin (2017). This research aims to empirically prove the significant influences of financial performance towards value of firm. This research chose the population in basic and chemicals industry listed on Indonesia Stock Exchange during the period of 2009-2014. The result of this study is there is significant influence of debt to equity ratio towards price to book value in basic industry and chemicals sector. Debt to equity ratio has negative influence towards the price to book value, which is indicated by coefficient regression of -1.028114. It means that an increase in debt to equity ratio will decrease the price to book value.

The study conducted by Chowdhury and Chowdhury (2010) attempt to empirically investigate the influence of debt-equity ratio on the value of shares given different sizes, industries and growth opportunities with the companies incorporated in Chittagong Stock Exchange (CSE) and Dhaka Stock Exchange (DSE) of Bangladesh. To provide a comparative analysis and give robustness of the analysis they draw samples from the four most leading sectors of industry including chemical and pharmaceutical engineering, fuel and power, and food and allied. Their empirical findings show strong positively correlated association between the dependent and independent variables.

The other study conducted by Sasya Sabrina, Armanto Witjaksono, and Lusianah (2018) about The Most Influential Factors Toward Firm Value (Case Study

In Indonesia) provides empirical evidence that financing decision does not affect firm value. The purpose of this research is to investigate the most influential factor among investment decision, financing decision, and dividend policy toward firm value that uses 109 samples from publicly listed manufacturing companies in Indonesia Stock Exchange (Bursa Efek Indonesia) in 2014, 2015, and 2016.

The other research that conducted in Jakarta Stock Exchange in which now become Indonesia Stock exchange. This research made by Handoyo Wibisono (2008) on 21 companies listed on Jakarta Stock Exchange, and this research approved that firm's value is not determined by capital structure decision, because the investors do not respond to any changes on capital structure. It is showed by significant that goes beyond 0,05. Beside that from the equation, the effect of capital structure on firm value is only 0,31% (adjusted R^2 =0,0031), and 99,69% firm value is affected by the other factors out of capital structure.

The other research conducted by Elsa Imelda and Sheila Sheila (2017) examined empirically the influence of capital structure, dividend policy, and ownership structure toward firm value with growth opportunity as moderating variable. They used manufacturing industries listed on Indonesia Stock Exchange during 2012-2014 and there are 96 samples are used in this research. The method of analysis was multiple linear regression using Eviews 7 program. The result shows that there is a significant relationship between capital structure and ownership structure with firm value in corporate with high growth opportunity.

The author believe that capital structure would impact on firm value as the manager has a important role in making a financing decision for the company. Since

that and also based on those previous research and the previous theory, the author conclude that capital structure has positive effect to the firm's value. So the hypothesis for this research is:

Ha: Capital Structure positively affects the firm value