CHAPTER II

THEORY BASIS AND HYPOTHESIS DEVELOPMENT

2.1 Financial Statements

General purpose financial reporting objectives form the basis of the Conceptual Framework (IFRS, 2018). Other aspects of the Conceptual Framework - qualitative characteristics, and cost constraints, useful financial information, the reporting entity concept, elements of financial statements, recognition and derecognition, measurement, presentation, and disclosure - flow logically from its purpose. The objective of financial reporting is to provide financial information that is useful to users in making decisions relating to providing resources to the entity. These decisions include decisions regarding:

1. buying, selling or holding of equity or debt instruments;
2. providing or settling loans and other forms of credit.
3. Voting, or otherwise influencing management's actions.

The decisions described in the paragraph above depend on the returns that current and potential investors, lenders and other creditors expect, for example dividends, principal and interest payments or an increase in market price. Investors, lenders and other creditors' expectations of returns depend on assessing the amount, timing, and uncertainty of (the prospect of) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Current and potential investors, lenders, and other creditors need information to assist them in this assessment. To make the judgments described in

the preceding paragraph, current and potential investors, lenders and other creditors need information about:

1. the entity's economic resources, claims against the entity and changes in those resources and claims;
2. how efficiently and effectively management has discharged its responsibilities to use the entity’s economic resources.

Many current and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports to obtain the financial information they need. Therefore, they are the main user general purpose of financial reports. However, general purpose financial reports do not and do not provide all of the information current investors, potential investors, lenders and other creditors need. Such users need to consider relevant information from other sources, for example, general economic conditions and expectations, political events and conditions, and the future prospects of the industry and the entity. General purpose financial statements are not designed to demonstrate the value of a reporting entity, but provide information to assist current investors, potential investors, lenders and other creditors in estimating the value of the reporting entity (IFRS, 2018).

2.2 Qualitative Characteristics of Useful Financial Information

The qualitative characteristics of useful financial information discussed in this chapter identify the types of information that are likely to be of greatest use to current and potential investors, lenders and other creditors in making decisions about reporting entities based on information in financial statements (financial

information). Financial statements provide information about a reporting entity's economic resources, claims against a reporting entity, and the effects of transactions and other events and conditions that change those resources and claims. (The Conceptual Framework refers to this information as information on economic phenomena.) Some financial reports also include explanatory material about the reporting entity's management expectations and strategies, as well as other types of forward-looking information.

The qualitative characteristics of useful financial information are applied to financial information available in financial reports, as well as to financial information available in other ways. Cost, which is a pervasive constraint on the reporting entity's ability to provide useful financial information, applies similarly. However, considerations of applying qualitative characteristics and cost constraints may differ for different types of information. The qualitative characteristics of useful financial information (IFRS, 2018) are divided into two, namely fundamental qualitative characteristics and enhancing qualitative characteristics. For financial information to be useful, it must be relevant and represent exactly what will be represented. The usefulness of financial information can be increased if the information is comparable, verifiable, timely, and understandable. Fundamental qualitative characteristics include relevance and precise representation which can be explained by the following description:

2.2.1 Fundamental Qualitative Characteristics

a) Relevance

Information is relevant if it is capable of making a difference to the decision made by users. Financial information is capable of making a difference in decisions if it has predictive value or confirmatory value.

b) Faithful Representation

Financial reports represent economic phenomena in words and numbers. In order to be useful information, in addition to representing relevant phenomena, financial information must also accurately represent the substance of the phenomena to be represented. In many ways, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form will not accurately represent the economic phenomenon

2.2.2 Enhancing Qualitative Characteristics

a) Comparability

User decisions include selecting alternatives, for example selling or owning investments, or investing in one reporting entity or another. Therefore, information about a reporting entity is more useful when

compared with similar information about other entities and with similar information about the same entity for other periods and dates.

b) Verifiability

Verifiability helps assure users that the information accurately represents economic phenomena as it should be. Verifiability means that multiple independent observers with varying knowledge can reach a consensus, although not always agree, that certain descriptions are correct representations. Quantification information does not have to be a separate point of estimate to be verified. Various possible numbers and associated probabilities can also be verified.

c) Timeliness

Timeliness means providing information to decision makers at the right time so that it can influence their decisions. In general, the older the information is, the less useful it is. However, some information may continue to be timely even in the long term after the end of the reporting period, for example, some users need to identify and assess trends.

d) Understandability

Classifying, characterizing and presenting information clearly and concisely can make the information understandable. Some phenomena are inherently complex and not easy to understand.

Excluding information about this phenomenon from financial reports might make the information in those financial statements easier to understand. However, the report will be incomplete and therefore potentially misleading.

2.3 Financial Ratios

Financial ratios are a company's financial analysis tool for assessing the performance of a company based on the comparison of financial data contained in the financial statements (balance sheet, profit / loss statement, cash flow statement). The ratio describes a relationship or balance (mathematical relationship) between a certain amount and another. Ratio analysis can be used to guide investors and creditors to make decisions or considerations about the company's achievements and future prospects. One way of processing and interpreting accounting information, which is expressed in relative or absolute terms to explain certain relationships between one number and another from a financial statement.

Research conducted by Foster (1986) in Ardhinita (2009) explains one of the things that can encourage the analysis of financial statements using financial ratio models, namely examining the empirical relationship between financial ratios and estimates or predictions of certain variables (for example bankruptcy). A similar thing is also explained by Munawir (2002) regarding financial ratios which can basically be used:

1. For the purposes of measuring overall financial work (overall measures).

2. For the purposes of measuring profitability or profitability, the ability of a company to benefit from its operations (profitability measures).
3. For the purpose of investment testing (test of investment utylization).

Rating agencies that issue bond ratings against companies that issue bonds, usually determine the bond ratings based on analysis of available accounting data. Financial ratios are one of the variables obtained from accounting data, therefore they are used as variables that are thought to affect the determination of bond ratings. Several financial ratios are evaluated such as:

1. Leverage Ratio

   This ratio is used to measure the balance of the proportion between assets financed by creditors (debt) and those funded by company owners (equity). This ratio is used to measure the extent to which the company uses debt to finance its investments. If this ratio is high enough, then it shows the high use of debt, so this can make the company experience financial difficulties, and usually have a fairly large risk of bankruptcy. Companies that do not have leverage mean using their own capital 100%. The use of debt itself for companies contains three dimensions:

   a) Lending will focus on the amount of collateral for the credit provided.
   b) With the use of debt, if the company gets profits it will increase.

c) By using debt, the owner gets funds and does not lose control of the company. Investors and creditors will benefit as long as the return on corporate debt exceeds interest costs and if there is an increase in the market value of securities (Syahrul and Nizar, 2000 in Adrian, 2011).

The greater the leverage of the company, the greater the risk of failure of the company, and the lower the leverage of the company, the better the ranking given to the company (Burton et al, 1998 in Adrian, 2011).

2. Liquidity Ratio

According to Sartono (2002), liquidity is the company's ability to pay short-term financial obligations on time. The liquidity of a company is indicated by the size of current assets, which is defined as current assets, namely assets that are easy to convert into cash, such as cash, securities, accounts receivable and inventories. The higher the liquidity ratio, the greater the company's ability to meet its short-term obligations. Research by Burton et al (2000) in Adrian (2011) states that a high level of liquidity will indicate the strength of the company's financial condition so that it will financially affect the prediction of bond ratings. So the higher the liquidity, the higher the company's rating.

3. Profitability Ratio

According to Sartono (2002), profitability is the company's ability to earn profits in relation to sales, total assets and own capital.

Meanwhile, according to Mamduh and Halim (2000), profitability is a ratio that measures the company's ability to generate profits (profit) at the level of sales, assets and certain share capital. According to Brotman (1989) and Young (1998) in Adrian (2011), the higher the level of company profitability, the lower the risk of inability to pay (default), the better the ranking given to the company.

2.4 Credit Rating Agency

The bond rating issuer is a credit rating agency (CRA). This credit rating can be used to measure creditworthiness, ability to repay debts, and influence the interest rates charged on those debts. PEFINDO is a company that has a permit and is a market leader in granting ratings in Indonesia. In granting ratings, PEFINDO also cooperates with rating companies abroad, namely Standard and Poor's or often abbreviated as S & P’s (Pertiwi, 2014).

The rating level given by PEFINDO on the company's financial strength can be described with 18 points or levels as follows (www.pefindo.com): idAAA; idAA +; idAA; idAA-; idA +; idA; idA-; idBBB +; idBBB; idBBB-; idBB +; idBB; idBB-; idB +; idB; idB-; idCCC and idD. The plus or + sign indicates that the rating given indicates that the rating given is relatively strong and above the average of the respective category, while the minus sign or - is the rating given relatively weak and below the average of the respective category. Other information which can be further defined by the following description:

a. AAA

Companies with this rating have financial security superior relative to other companies in Indonesia. This rating is the highest rating given by PEFINDO to the company.

b. AA

Companies with this rating have very strong financial security relative to other companies in Indonesia, with a slight difference compared to higher rankings.

c. A

Companies with this rating have strong financial security relative to other companies in Indonesia, but may be affected by changes in adverse business conditions compared to other companies with higher ratings.

d. BBB

Companies with this rating have adequate financial security relative to other companies in Indonesia, but are more likely to be affected by changes in adverse business conditions than other companies with higher ratings.

e. BB

Companies with this rating have a slightly weak financial security relative to other companies in Indonesia. Positive things are there, but worsening business conditions can lead to the inability to fulfill financial commitments.

f. B

Companies with this rating have weak financial security relative to other companies in Indonesia. Deteriorating adverse business conditions will weaken the ability to fulfill its financial commitments.

g. CCC

Companies with this rating have financial security vulnerable and dependent on favorable business conditions to meet its financial commitments.

h. SD

Companies with this rating have has failed to pay one or more of its financial obligations, rated or unrated, when it came due, but still makes timely payments on its other obligations.

i. D

Companies with this rating are in the regulatory supervision status with respect to their financial condition. During the period of supervision, the regulator can prioritize a group of class of obligations and not to another or pay for one obligation while not to another. The rating does not apply to companies subject to supervision due to non-financial measures such as violations of behavior in the market.

2.5 Bonds

Bonds are long-term debt that is paid back at maturity with fixed interest if any (Hartono, 2009). For investors there are several advantages to buying bonds. First, investors get fixed income in the form of coupons. Second, investors can also trade the bonds they own. Third, investors have the first rights over the company's assets if the company is liquidated.

Meanwhile, according to Sulistyastuti (2002) what is meant by bonds (bonds) are fixed income securities issued in connection with a debt agreement. Bonds have the same characteristics as other fixed income securities, namely:

1. Securities that have legal force,
2. Has a certain period or maturity period,
3. Providing regular periodic income,
4. There is a face value. The face value of the bonds is also called par value, par value, stated value, face value.

2.6 Bond Ratings

A bond rating is a symbol of character given by a rating agent to indicate the risk of a bond (Hartono, 2009). Bond rating is influenced by (1) the proportion of capital to debt, (2) the level of profitability of the company or the party issuing the bonds, (3) the degree of certainty in generating income, (4) the size of the company or the party issuing the bonds, (5) the amount of loans subordination issued by the company or the party issuing the bonds (Rahardjo, 2003).

PEFINDO's rating methodology covers three main risks, namely,

1. Financial Risk

Includes aspects of asset quality, profitability ratio, classification of assets and liabilities, capital adequacy ratio, level of debt management, and interest payment adequacy ratio.

2. Industry Risk

   Includes industrial competition, prospects and capital market availability of raw materials, industrial structure, influence of government policies, and other economic policies.

3. Business Risk

   Includes aspects of management, company reputation, and indenture agreements (sinking funds, debt assets, dividend tests, mergers, and sale of assets).

2.7 Signal Theory

Signal Theory (SignallingTheory) is an information signal needed by investors to determine whether the investor will invest or not. This is because before and after doing investment, many things that must be considered by investors. This theory serves to make it easier for investors to develop the capital needed by the company in determining the direction of the company's future prospects, Afiani (2012).

Signal theory explains the reasons for companies to provide financial report information to external parties related to the asymmetry of information between company management and outsiders where the company management has more information and knows the company's prospects in the future. Companies can provide information related to bonds such as bond ratings. Bond ratings provide

information about the issuer's financial performance and business position. Because the rating appraisal considers financial factors, the company's management tends to carry out earnings management so that it has an impact on the acquisition of high bond ratings.

Signal theory emphasizes information. Signal theory shows the existence of information asymmetry between company management and various interested parties, related to the information released by the company.

With regard to information asymmetry, it is very difficult for investors and creditors to distinguish between companies that are performing well and companies that are performing poorly. Information in the form of issued bond ratings is expected to signal the company's financial condition and illustrate the possibilities that occur in relation to debt owned by Ginting (2010).

Signal theory also suggests how companies should signal users of financial statements. Information in the form of issued bond ratings is expected to signal the company's financial condition and illustrate the possibilities associated with the debt it has. Therefore, in making investment decisions, investors always base the signals given by the company, one of which is the bond rating.

2.8 The Results of Previous Research

Wisnu, Bramasta (2012) in his research on *"Pengaruh Manajemen Laba dan Rasio Keuangan Perusahaan Terhadap Peringkat Obligasi"* found that earning management have significant effect to bond rating. Liquidity, leverage, solvency ratio has no significant effect to bond rating. While profitability ratio and productivity ratio have significant effect to bond rating.

Through his research *"Analisis Pengaruh Rasio Keuangan Terhadap Peringkat Obligasi Perusahaan Manufaktur yang Terdaftar di Bursa Efek Indonesia*" Kingkin (2010, Management Insight) found that Return on Assets and Firm Size was positive effect on bond ratings. This shows that the Return on Assets and Firm Size can affect the good and bad bond rating companies manufacturing. While the Current Ratio and Debt-to-Equity Ratio has no effect on bond ratings. This means high or low level of these variables did not affect the good and bad bond rating companies, especially manufacturing firms in Indonesia Stock Exchange.

Research conducted by Wastam Wahyu Hidayat *"Pengaruh Leverage dan Likuiditas Terhadap Peringkat Obligasi: Studi Kasus Perusahaan Non Keuangan di Indonesia"* has the following conclusions:

1. Leverage (Debt to Equity Ratio) partially has a significant negative effect on the bond rating of non-financial companies listed on the Indonesia Stock Exchange, meaning that the more debt, the company's bond rating will decrease due to reduced public trust and vice versa.
2. The Current Ratio partially has a significant positive effect on the bond ratings of non-financial companies listed on the Indonesia Stock Exchange. This means that the higher the current assets, the bond rating will increase because the public will trust the company and vice versa.

Next research is the research conducted by Ni Made Sri Kristina Sari and Ida Bagus Badjra have the number of samples taken as 20 bonds of companies of

the financial sector 2012-2014, using purposive sampling method. The analysis shows that liquidity is a significant negative effect on the bond rating. The size of the company and significant positive effect on the bond rating. Leverage positive effect and no significant effect on bond ratings. Warranty positive and significant impact on bond ratings. Companies should pay more attention and be able to increase the value of the company's liquidity so that companies ranked categorized as investment-grade bonds because investors are more interested in investing in bonds in the company investment-grade category.

Purwaningsih (2008) has done her research about *"Pemilihan Rasio Keuangan Terbaik Untuk Memprediksi Peringkat Obligasi: Studi Pada Perusahaan Manufaktur yang Terdapat di BEJ".* This research was conducted on companies that have bonds whose bond ratings were issued by PEFINDO in April 2000-2006. There are two main findings in this research, namely (1) financial ratios which can be applied to predict bond rating are SFA (productivity ratio), CFOTL (solvability ratio), and LTLTA and NWTA (the two are leverage ratio) (2) the best financial ratio to predict CACL (liquidity ratio) bond rating with loading factor valued 0.940.

Table 2.1 Previous Research

Title	Variables	Object	Research Result
"Pengaruh Manajemen Laba dan Rasio Keuangan Perusahaan Terhadap Peringkat Obligasi"	X1: Earnings Management X2: Financial Ratio Y1: Bond Emissions Y2: Bond Ratings	companies that issue bonds and are listed on the OTC-FIS (Over The Counter-Fixed Income Service) Indonesia Stock Exchange from 2006 to 2009.	Earning management has a significant effect on bond issuance, earnings management has a significant effect on bond ratings, leverage ratio, solvency and liquidity have no significant effect on bond ratings, profitability and productivity ratios have a significant effect on bond ratings.
"Analisis Pengaruh Rasio Keuangan Terhadap Peringkat Obligasi Perusahaan Manufaktur yang Terdaftar di Bursa Efek Indonesia"	X1: Current Ratio X2: Debt-to-Equity Ratio X3: Return on Assets X4: Firm Size Y: Bond Ratings	A company engaged in the non-financial sector, and its ranking was announced by PEFINDO in 2009-2010 and has published financial reports for the year 2008-2009	ROA and Firm Size can have positive effect on bond ratings while the Current Ration and Debt-to-Equity ratio has no effect on bond ratings.

"Pengaruh Leverage dan Likuiditas Terhadap Peringkat Obligasi: Studi Kasus Perusahaan Non Keuangan di Indonesia"	X1: Leverage X2: Liquidity Y: Bond ratings	Financial reports of companies listed on the IDX for the period 2012-2014. Financial statements of companies issuing bonds and rated by PEFINDO.	Leverage has significant negative effect on bond ratings while Liquidity has significant positive effect on bond ratings.
"Pengaruh Likuiditas, Ukuran Perusahaan, Leverage dan Jaminan Terhadap Peringkat Obligasi Pada Sektor Keuangan"	X1: Liquidity X2: Firm Size X3: Leverage X4: Warranty Y: Bond Ratings	20 bonds of companies of the financial sector 2012-2014	The analysis shows that liquidity is a significant negative effect on the bond rating. The size of the company and significant positive effect on the bond rating. Leverage positive effect and no significant effect on bond ratings. Warranty positive and significant impact on bond ratings.
"Pemilihan Rasio Keuangan Terbaik Untuk Memprediksi Peringkat Obligasi: Studi Pada Perusahaan Manufaktur yang Terdapat di BEJ"	X1: Leverage X2: Liquidity X3: Solvability X4: Profitability X5: Productivity (turnover) Y: Bond Ratings	Bonds of manufacturing companies listed in the bond rating in April 2000 to April 2006 which registered in PEFINDO and have their complete financial report	There are two main findings in this research, namely (1) financial ratios which can be applied to predict bond rating are SFA (productivity ratio), CFOTL (solvability ratio), and LTLTA and NWTA (the two are leverage ratio) (2) the best financial ratio to predict CACL (liquidity ratio) bond rating with loading factor valued 0.940.

2.9 Hypothesis Development

2.9.1 Liquidity

The liquidity ratio describes the company's ability to settle its short-term obligations (Harahap, 2010). Companies that are liquid and have more current assets than current liabilities are able to properly meet their financial obligations on time. One of the tools used to measure liquidity is to use the current ratio (Mahfudhoh and Cahyonowati, 2014).

Liquidity problems are related to the problem of a company's ability to meet its financial obligations which must soon be fulfilled. The number of payment instruments (liquid assets) owned by a company at one time is the power to pay for the company concerned. A company that has "the power to pay" may not be able to fulfill all its financial obligations that must be fulfilled immediately, or in other words, the company certainly has the ability to pay.

Companies with a high level of liquidity will be preferred by investors because they think that the company will be able to return the amount of money invested along with the agreed fee when due. The higher the liquidity of a company, the better the corporate bond rating. The company has a great opportunity to be ranked as high investment grade. Ownership of current assets that is higher than current debt causes the company to have the ability to meet short-term obligations to investors on time. This condition will make it easier for companies to attract investors to invest in their company (Amalia, 2013).

The liquidity ratio is a ratio that shows the ability of company managers to meet debt or pay short-term debts. A high level of liquidity can signal that the company has the ability to perform its obligations in a relatively short period of time. The company's strong financial condition can indicate that the possibility of repaying its long-term obligations will also be better, so that it will affect the bond rating that will be given which is higher bond ratings. Sari in her research also stated that there is a significant influence between liquidity and bond ratings. This is in line with research conducted by Almilia and Devi which states that a high level of liquidity will indicate the strength of the company's financial condition so that it will financially affect the bond rating. Based on this description, the following hypothesis is proposed:

H1: Liquidity ratio have positive effect on bond ratings

2.9.2 Profitability

Profitability is the company's ability to earn a profit in relation to sales, total assets and own capital. Profitability provides an overview of how effectively the company operates so that it provides benefits for the company (Linandarini, 2010). Mark et al (2001) said that the profitability ratio as measured by ROA has a positive effect on profit growth because this ratio measures the company's ability to generate net income based on a certain asset level. If the profitability is high, the bond is included in investment grade, because high operating income indicates that the company is working efficiently.

Profitability analysis aims to measure the company's ability to earn profits, both in relation to sales, assets, and own capital. So the results of profitability can be used as a benchmark or an illustration of the effectiveness of management performance in terms of the benefits compared to the sales and investment results of the company. Financial reports such as balance sheets, income statements and cash flows are analyzed using analytical tools in accordance with the needs of the analyst.

Financial analysis tools include: analysis of sources and use of funds, comparative analysis, trend analysis, Leverage analysis, break even analysis, financial ratio analysis and others. Ratio is a method for assessing a company's financial condition based on ratio calculations based on quantitative analysis, which shows the relationship between one element and another in the income statement and balance sheet. In addition, the company's financial ratios are used which allow comparing the ratio of a company with other similar companies or with the industry average ratio.

Profitability ratios measure the company's ability to generate profit from sales, certain total assets and profit from its own capital. Profitability provides an overview of the effectiveness of the company in generating profits for the company. The higher the profitability ratio, the more effective the company is in generating profits, so that the company's ability to pay off loan principal and pay interest will be better and the bond rating will be higher. The higher the bond rating, the signal that the probability of the company's failure to fulfill its obligations is lower.

Research conducted by Yuliana found that profitability has an influence on bond ratings, meaning that the higher the level of company profitability, the lower the risk of inability to pay and the better the rating given by the PEFINDO to the company. This is in line with the results of research conducted by Bouzoita & Young in Burton, Adam & Hardwick (1998) which states that the higher the profitability of a company, the better the company's ability to pay periodic interest and pay off loan principal so that it can increase the company's bond rating.

H2: Profitability ratio has a positive effect on bond ratings

2.9.3 Leverage

The leverage ratio is a financial ratio that shows the proportion of debt used to finance investment to capital owned (Mahfudhoh and Cahyonowati, 2014). The greater the leverage of the company, the greater the risk of failure of the company. The lower the leverage of the company, the better the rating given to the company (Aulia, 2014). This indicates that the high level of leverage results in the company being exposed to the risk of company failure because it tends to have low ability to pay off its obligations and the bond rating is down. The lower the leverage, the better the rating given to the company (Arifman, 2013).

According to Magreta (2009) the leverage ratio is used to measure the extent to which a company uses debt to finance its investment. The low value of the leverage ratio means that only a small proportion of assets are funded by debt and the lower the risk of company failure. Thus, the lower

the leverage of the company, the higher the ranking given to the company. The use of debt for companies contains three dimensions, namely:

1. Lending will focus on the amount of collateral for the credit provided.

2. With the use of debt, so if the company gets a profit it will increase.

3. By using debt, the owner gets funds and does not lose control of the company. Investors and creditors will benefit as long as the profit on the company's debt exceeds interest costs and if there is an increase in the market value of securities (Amrullah in Linandarini, 2010).

The leverage ratio is the ratio used to measure the extent to which the company's assets are financed with debt. That is, how much debt the company bears compared to its assets. The greater the company's leverage ratio, the greater the risk of company failure. The lower the company's leverage ratio, the better the bond rating given by the PEFINDO to the company. This high ratio means that most of the assets are financed with debt and this causes the company to face default problems or poor ratings. Because there is a possibility of greater the leverage ratio of the company, it means the greater the risk of failure of the company then the ratings agency will give bad performance or lower ratings for the company. Conversely, the lower the company's leverage ratio, the greater the company's rating.

According to Burton's Research, et al. that the value of a small leverage ratio in a company, the smaller the assets that are funded by debt, so that the less likely the company will commit default which will ultimately affect the bond rating. Other research conducted by Septyawanti revealed that there is an effect of leverage on bond ratings.

H3: Leverage ratio has a negative effect on bond ratings