CHAPTER II

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1. Basel 3

As the event of this research, the explanation of Basel 3 regulation will be brief. One of the key lessons of the crisis has been the need to strengthen the risk coverage of the capital framework. Failure to capture major on- and off-balance sheet risks, as well as derivative related exposures, was a key destabilizing factor during the crisis. The Committee's revisions to the standardized approach for credit risk enhance the regulatory framework by:

- improving its granularity and risk sensitivity. For example, the Basel II standardized approach assigns a flat risk weight to all residential mortgages. In the revised standardized approach mortgage risk weights depend on the loan-to -value (LTV) ratio of the mortgage;
- reducing mechanistic reliance on credit ratings, by requiring banks to conduct sufficient due diligence, and by developing a sufficiently granular non-ratings-based approach for jurisdictions that cannot or do not wish to rely on external credit ratings; and
- as a result, providing the foundation for a revised output floor to internally modelled capital requirements (to replace the existing Basel I floor) and related disclosure to enhance comparability across banks and restore a level playing field

The LCR promotes the short-term resilience of a bank's liquidity risk profile. It does this by ensuring that a bank has an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to meet its liquidity needs for a 30-calendar day liquidity stress scenario. It will improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy.

While, The NSFR is a significant component of the Basel III reforms. It requires banks to maintain a stable funding profile in relation to their on- and off-balance sheet activities, thus reducing the likelihood that disruptions to a bank's regular sources of funding will erode its liquidity position in a way that could increase the risk of its failure and potentially lead to broader systemic stress. The NSFR will become a minimum standard by 1 January 2018. (Committee, 2011)

2.2. Stakeholder theory

Due to the nature of this research, it is focused on the perspectives of the users rather than the bank. Due to the changes on banks regulation and there would be actions, the stakeholders must have access to its economic performance in order to make their judgement. According to (ulum, 2017), organization management is required to carry out operation that are relevant to their stakeholders and report back on these activities to stakeholders, based on stakeholder theory. Stakeholders have the freedom to ask for clarification on how the organization's operations affect them. According to Deegan (deegan, 2004):

"Stakeholder theory puts and emphasis on corporate transparency that goes far beyond accounting or economic outcome. This principle states that, in order to fulfill real or understood stakeholder needs, companies may opt to willingly reveal details about their economic, social, and intellectual performance over what is mandated by regulation."

A company would aim to satisfy the financial information needs of groups such as staff, vendors, and customers, as well as the society, using this strategy (Robbins & Coulter, 2002)

According to (Zsolnai, 2006) "*Business organizations effect the fate and survival of natural being and the life conditions of present and future generations. Thus, nature society and future generation should be included among the stakeholders of business*". Stakeholder theory implies that companies must pay attention to stakeholders, because they are parties who influence and are influenced either directly or indirectly on the activities and policies taken and carried out by the company. If the company does not pay attention to stakeholders, it is not impossible that it will reap protests and can eliminate stakeholder legitimacy. Therefor it is in the company's best interest to satisfy the informational needs of its stakeholder by reporting their financial activity.

2.3. Financial report

In order to satisfy the stakeholders needs for information, the company should make a financial report. The objective of financial report is providing financial information about a reporting entity that is useful to current and potential

investors, lenders, and other creditors in making decisions about providing resources to the entity. The key / primary user needs the knowledge about the entity's resources not only to measure the entity's potential for possible net cash inflows, but also to determine how effectively and efficiently management has carried out their obligations to use the entity's current capital.

Since financial reporting is modular, there are no forms in the financial statements, and since financial reporting is part of the annual report, some people consider financial reports to be annual reports as well. Several items in financial statements typically including the following:

1. Company history / profile
2. Highlights from the stock market
3. Financial performance result discussion
4. Consolidated financial statements
5. Information about the company / company data

General purpose financial reports, according to the IFRS Framework, cannot contain all of the information that users need to make economic decisions. They will have to take into account relevant data from other sources as well. The IFRS Framework notes that other parties, such as prudential and market regulators, can find general purpose financial reports helpful.

2.4. Qualitative characteristic of financial information

Since our research took place in Indonesia, Indonesian banks, the structure of said report will be based on KKPK (*Kerangka Konseptual Pelaporan Keuangan*). In KKPK, it explains the qualitative characteristics of financial information. There are 7 major points which are: relevance, materiality, faithful representation, comparability, verifiable, timeliness, and understandability.

- Relevance

  Financial data that is relevant to the user will make a difference in their decision making. Information may be able to make a difference in decisions even if some users choose not to take advantage of the information or have become aware of the information from other sources.

- Materiality

  Information is material if the omission or misstatement of the information is expected to adequately influence the decisions that primary users of general-purpose financial statements make on the basis of those reports, which provide financial information about a particular reporting entity. To put it another way, materiality is the element of interest that is unique to a single entity depending on the nature or magnitude, or both, of the objects to which the details refer in the context of each entity's financial statements.

- Faithful representation

In words and percentages, financial reports depict economic phenomena. Financial information, in addition to describing related phenomena, must correctly reflect or present the substance of the phenomena to be described in order to be valuable information. The essence of an economic concept and its legal structure are similar in several respects. If they are not identical or similar, presenting only legal facts would not adequately reflect the economic phenomena.

- Comparability

The user's decision includes selecting several options, such as selling or owning an investment, or investing in one reporting company or another. Therefore, information about a reporting entity is more useful when compared with similar information about another entity and with similar information about the same entity for other periods and dates.

- Verifiability

Verifiability assures users that the data correctly depicts economic phenomena as they should. Verifiability refers to various independent observers with varying knowledge can reach a consensus, even though not always agree, that certain descriptions are valid representations.

- Timeliness

When talking about timeliness, it all about giving facts to decision makers at the right time so that it will affect their choices. The older the information, the less valuable it is in general. Some material, on the other hand, may continue to be timely even after the monitoring period has ended; for example, some user may need to recognize and determine patterns or trends.

- Understandability

Information can be understandable by classifying, characterizing, and describing it in a straightforward and concise manner. Any phenomena are by their very nature complex and difficult to comprehend. It is possible that excluding information about these phenomena from financial reporting would make the information in such financial statements easier to comprehend.

We assume that for the purposes of this research all companies used as sample will provide their financial report on the basis of those 7 points that are listed in KKPK.

2.5. Efficient market hypothesis

As for the stakeholders using this hypothesis by (Hartono, Metodologi Penelitian Bisnis, 2007) we assume that the market will know and be informed if there are a new financial report published by companies and there for creates an efficient market. For further explanation there are 2 types of efficient market:

1. Information-Based Market Efficient

   A. A Weak Form Efficient Market is one in which the values of assets fully reflect historical data. Advocates for the weak form efficiency theory believe that if the fundamental analysis is used, undervalued and overvalued stocks can be determined, and investors can research companies' financial statements to increase their chances of making higher-than-market-average profits.

   B. Semi-strong Form Efficient Market is a market in which the prices of securities fully reflect all published information, for example earnings announcements, dividend announcements, announcements of mergers and acquisitions, government regulations or regulations from regulators that impact remittent companies. Those who subscribe to this version of the theory believe that only information that is not readily available to the public can help investors boost their returns to a performance level above that of the general market.

   C. Strong Form Efficient Market is a market where security prices fully present all information including private information. Advocates for this degree of the theory suggest that investors cannot make returns on investments that exceed normal market returns, regardless of information retrieved or research conducted.

2. Decision-Based Market Efficiency

Decision-based market efficiency is also one of a semi-strong form of market efficiency based on distributed information. The difference is that

if market efficiency in information considers only one factor, namely the availability of information, then market efficiency by decision considers two factors, namely the availability of information and the sophistication of market players. If the market is decision-efficient, market participants can make correct decisions from the signals given by the emitted companies.

Based on this hypothesis we assume that the market that we are currently researching is an efficient market. So, every investor is aware and will act based on the reports that are published by the company.

2.6. Financial statement & annual reporting

As financial statement is part of the company's annual report, we will be focusing on the Annual report as it has the information needed. According to Harahap (Harahap, 2013) financial reports explain a company's financial situation and performance of activities at a certain time or over a specific period of time. Balance sheets, income statements, or business results, cash flow reports, and adjustments in financial position reports are examples of common financial statements.

Indonesian Institute of Accountants (2015) define financial reports in Financial. Accounting Standards (SAK) No.1, state that financial statements are part of the financial reporting process. Financial statements are a formal presentation of entity's financial status and financial results. Balance sheets, income statements, statements of changes in financial position (which may be viewed in a variety of forms, such as cash flow statements), notes and other reports and

explanatory material that are an indispensable part of financial statements are normally included in complete financial statements. It is also providing schedules and other report-related material, such as financial data on industrial and regional sectors, as well as disclosures of the results of changes in price.

The forms of corporate financial statements that are the key facts for consumers of financial statements, according to Harahap (2013) are balance sheets and profit and loss accounts. The balance sheet and profit and loss are explained as follows:

A. Balance sheet

The balance sheet, often known as financial position, depicts a company's financial situation at a certain point in time, also referred to as of a certain date, such as December 31, 2020. The balance sheet defines situation is split into two parts: the debit side for assets and the credit side for liabilities (Harahap, 2011). There are classifications in the balance sheet, such as:

1. Asset

   Assets described by PSAK as economic benefits gained or managed in the future by some entities as a result of previously completed transaction. This asset is made up of three parts:

   • Current Asset

     Current assets are capital and other commodities that are intended to be sold, invoiced, or used by the organization over the course of a year or

one operation period. As representation of existing properties, including prepaid expenditures, trade / trade receivables, equipment, cash, office equipment. Liquidity, or the ability to turn investments into currency, must be considered when preparing current assets.

- Fixed Asset

Except for land depreciation, fixed assets are tangible assets purchased for us in business activities that have a useful life of more than one year. Equipment, vehicles, building, and machinery are examples of fixed assets.

- Intangible Asset

Assets obtained for use of the company's activities are known as intangible assets. The primary distinction between fixed assets and intangible assets is their physical and the amount of usable life they can provide to the organization. When an intangible object does not have a physical structure and the asset useful existence is unknown.

2. Liability

Liability, according to Harahap (2012), is the sum that must be passed from one year to the next based on documents kept in compliance with accounting standards. Present liabilities, long-term liabilities, and owner's capital are the types of liabilities.

- Current Liabilities

Liability can be classified as current liability if it can be paid within twelve months of the declaration of financial statements date or the company's usual period of activities. Trade payables and bank loans, for example (maturities of less than one year).

- Long-term liabilities

If the expected maturity period is longer than one year after the date of the declaration of financial condition, it is a long-term liability. Bonds payable is one of the examples of long-term liabilities.

- Equity / Owner's Capital

The remaining value of a company's assets after deducting liabilities is the owner's capital / equity, which is a part of the owner's interests in the company.

B. Profit and Loss

Profit and loss are a complete report of both revenue and expenses to determine the company's profit and loss over a given year. According to Harahap (2013), the income statements contain the following elements:

1. Revenue

The result of a company's selling of products or services is revenue, which is charged to consumers who receive services.

2. Expenses

Expenses re cash outflows of assets or the creation of liabilities over a time, and are triggered by the delivery of products or other profitable operations of the business which may be deducted from profits.

3. Profit/Loss

The disparity between revenue and total operating expenses for the year/period is profit/loss. If the difference is positive, profit will be generated, if the difference is negative, a loss will be generated. PSAK / Statements of Financial Accounting Standards specifies five categories of financial statement:

- The income statements are used to decide if the company made a profit or a loss within a given period
- Report on capital changes is used to determine whether the company's capital rose or reduced during a given period
- The balance sheet is used to calculate the value of a company's cash, loans, and capital at any given time
- The cash flow statements are used to determine how much cash the corporation has gained or lost over time
- Financial statements notes are used to explain the company's current situation in greater depth.

According to Hans (2016) the aim of financial statement is to offer information about an entity's financial status, financial results, and cash flow that is helpful to most consumers of financial statements when making economic

decision. Financial statements are often a form of management accountability for the managerial resources assigned to them in managing an entity. Accordingly, the financial statements are not designed for a particular reason, such as liquidating a company or assessing the fair value of an entity for mergers and acquisition purposes. It's also not tailored to serve the needs of a single entity, such as the controlling owner. Owners are the people who own equity securities.

The aim of financial statements, according to Hutauruk (2017), is to provide information about an entity's financial situation results, and adjustments in financial condition that is useful for a large number of users in making economic decisions. Many users' needs are supposed to be met by prepared financial statements. However, since financial statements typically represent the financial results of historical activities and are not needed to contain non-financial information, they do not provide all the information that consumer may need in making economic decision.

To summarize, the aim of financial statements is to provide financial information so that it can be used to determine the company's performance which will be used to make future decisions.

According to Hatauruk (2017), the aim of financial statement analysis is to break down financial statement items into smaller units of information and look for substantial or meaningful relationships between them, both quantitative and non-quantitative data, in order to get a better understanding of financial circumstances,

which is critical in making right decisions. Below is a summary of the usefulness of this financial statement analysis:

A. Can evaluate company performance
B. Able to forecast the company's financial situation
C. Can evaluate historical and current financial situations from a certain time perspective, such as financial position (assets, balance sheet, and capital), company operating results (results and costs), liquidity, solvency, activity, and profitability.
D. Examining the financial structure's composition (flow of funds)
E. Able to equate the company's current position to those of past periods as well as to normal industry standards or ideal standards.
F. Able to comprehend the company's financial state and circumstances, including its financial position, operating performance, financial structure, and so on.
G. Also capable of predicting the future potential of the firm

Financial statement analysis, according to Kariyoto (2017), entails applying different instruments and analysis methods to financial reporting and data in order to achieve meaningful and useful measurement in the decision-making process. The conversion of data into information is the first and most important feature of financial statement analysis. Below are the goals of financial statement analysis according to Kariyoto (2017):

1. Initial screening platform in selecting investment alternative or mergers

2. Forecasting methods for financial markets and results in the future
3. As a diagnostic tool for management problems and other issues
4. A method for assessing management efficiency
5. Give considerations a proper and formal foundation
6. Reducing and narrowing the scope of ambiguity of any decision-making phase that cannot be eliminated

2.7. DuPont model

Based on the financial report provided by banks we can find the relevant information needed to support this research quantitative data. Further explanation, using a part of DuPont model which explains that the profitability of banks is measured mainly by two ratios. The Return on Equity (ROE) that increase the wealth of the shareholders and the Return on Assets (ROA) that show to the investors how cable is the bank management to yield earnings and how profitably use the hole assets of the bank (Kyriazopoulos, DU PONT ANALYSIS OF THE WORLD SYSTEMIC BANKS). For this research we will only be using ROA because both ratois represent the same thing. While ROE helps investor understand how their investment are used, ROA halep the investor understand how the banks management is using their funds to generate income. For this reason, ROA would be better as a detterminant for banks profitability. The formula for ROA is as follows:

$$ROA = Net\ Profits\ /\ Total\ Assets$$

2.8. Share price

In order to find the affect after the financial report announcement we will look at the prices of the company's share. According to Jogiyanto (2011), the stock price is the current price on the stock exchange, and market members determine the share price. The stock market decides the price of these securities based on supply and demand. Share price, on the other hand, are described by Darmadji & Fakhrudin (2011), as prices that occur on the market at a specific time. Share values will fluctuate dramatically in a short period of time. It can shift in a matter of minutes, and even seconds. This is possible because demand and offer between a buyer and a seller of shares are also considerations, or in other word, it depends on it.

According to Musdalifahh Azis (2015), the share price is known as prices on the real market, and they are the simplest price to calculate since it is the price of a share on a moderate market, or if the market is closed, the market price is the closing price.

Based on the concepts above, we assume that the share price is the price of a share calculated when the stock market is open for business and is based on the demand and supply of shares. There for we can see how the market will change after the annual report announcement.

2.9. Regression model

Regression analysis is a form of predictive modelling technique which investigates the relationship between a dependent (target) and independent variable

(s) (predictor). This technique is used for forecasting, time series modelling and finding the causal effect relationship between the variables. We will be using regression model to find the relationship in our variables. Namely, Share price and ROA. We want to find out what is the relationship of ROA during the week of annual report announcement and the average Share price of those weeks since it would be a 7 days period. For the data to be normally distributed we use the natural log value of the share price. We will determine their relationship for each sample of banks that we have selected.

2.10. Previous research

The paper by Stefan W. Schmitz "The Impact of the Liquidity Coverage Ratio (LCR) on the Implementation of Monetary Policy" Sugests that the LCR, which is one of the Basel 3 regulation ratio that needed to be disclosed, disincentivizes banks to lend and/or borrow on the unsecured money market. (SCHMITZ, 2013)

The research from Putri Ziliwu and Dedi Wibowo "pengaruh CAR, ROA dan NPL terhadap harga saham perbankan yang terdaftar di BEI" conclude that ROA of a bank has a T-value of 0,548 which is not significant in a confidante level of 95 % but is significant in 90%.

Finally, the Research by Said in "Basel III New Liquidity Framework and Commercial Banks Profitability" Informs that the ability of banks in managing the stability of their funding sources as well as liquidity of its asset is an advantage to them and is translated into higher profitability. (Said R. , 2018)

2.11. Hypothesis development

The Share price is used the determine the position of said institution on the market and are used to measure a share is in the current market. The result is the Share price which is used to measure the effects of events, in this case Basel3 regulation, have on stock prices.

The ROA of a banks is used to determine the banks performance in profitability based on efficiency in using their assets. The higher the banks ROA would be the higher its profits are in relation to its asset. If the company generates sufficient profits and that is higher than the period before, many investors will be interested in buying shares and this increases stock price (Lee & Zhao, 2014). The ROA of a bank is published alongside its annual report which a favorable relationship with the share prices and abnormal return (Menike & Man, 2013)

Basel 3 is a banking regulation that changes how banks will manage their usable funds (bis.org, 2016) and limiting the amount of money they can use for day-to-day activities. For this reason, banking performance might be hindered due to less usable funds. Based on the explanation above the hypothesis of the research would be:

H1: There is a significant difference in market reaction after Basel 3 regulation announcement

2.12. Research model