CHAPTER I

INTRODUCTION

1.1 Background

Earnings is one of important information which is used by both internal and external parties to make decisions. According to Statement of Financial Accounting Concept (SFAC) no. 1 which is superseded by SFAC no. 8, earnings information is used by external parties to: (1) assess the performance of management, (2) help estimate the ability of earnings representative in the long term, (3) predict earnings, and (4) assess the risk of earnings in investment and credit loans. SFAC no 5 also explains that if statements of earnings is used in conjunction with statement of financial position, it will provides better basis for assessing the future cash flow prospects than what the cash flow statements do. Moreover, earnings can also show or predict the future of firms, whether they can keep going concern or not. The firm's going concern is very critical, especially for the external parties. As, if the firm cannot be going concern, the external parties will suffer huge losses.

While for the internal parties, earnings is one of determinants to make decisions. They have to decide the proper decisions that will keep their business run and sustain. They have some options to use those earnings, whether to internal funding, pay dividend, or investment. Those three decisions are commonly done in the business environment and so are in Indonesia. But, there is a unique phenomenon since Indonesian firms are tended not to choose to pay dividend. Atmaja (2013) found that after 1998, only 40% of the firms who had positive earnings that pay dividend and the rest were not. For example, PT Hero Supermarket Tbk which has good earnings growth had not paid dividend since its Initial Public Offering in 1989. Atmaja also argued that the reasons behind that phenomenon are: (1) market appreciates the earnings' report of quarter financial report more than the dividend declaration, and (2) some firms think that dividend payment is the second priority after the need of investment, internal funding, and target capital structure, or known as the dividend residual policy.

In the other hand, there are two kinds of investors that the firms have to think of. First, the investors who do not pay attention to dividend payment. They believe that the firm will create earnings in the future by using those fund to the prospective investment, thus put the firms in the growth stage, and result in higher capital gain in the future. So, if the firm does not pay dividend, it will not be considered as a big problem by those investors. Second, investors who prefer to get dividend rather than capital gain (bird in hand theory). They think that receiving dividend is more certain than waiting for the capital gain. Moreover, the investors worry if the firm does not pay dividend, those huge fund will be invested to risky project (Atmaja 2013). Therefore, it is crucial for the firm to have right investment decision not only to sustain the firm, but also to satisfy and give assurance to the investors.

Unfortunately, when a firm decides to invest, whether in financial assets (i.e. bonds, share, and etc.), in research and development, capital investment or others (Hansen and Mowen 2006), it will cover some risks. Those risks are caused by the uncertainty of the future that firms deal with. As an example is the research and development. Investment in R&D will be very costly and the benefit in the future is uncertain. Additionally, the expense that is spent to R&D cannot be directly capitalized unless the criteria have been fulfilled (PSAK no 20). So, it will directly deduct the firms' net income. Amir et al. (2007) and Yang (2014) also found that the R&D expenses have higher impact to uncertainty of future earnings than the capital expenditures. Those could be the reasons why Indonesian firms are not interested in R&D investment. It is proven by the financial report published by Indonesian Stock Exchange that in 2013, only 14 out of 137 (10%) listed manufacturing companies that present their research and development expenses in their financial report.

Since R&D expenditures are not considered as an attractive investment by Indonesian firms, then firms will intend to choose the capital expenditures as their investment decisions. Capital expenditures are belief to contain less risk than other investments. Moreover, capital expenditures are preferable since it supports their operational activity, and can be used to enlarge the economics of scale, hence will increase the profitability. Another reason is the capital expenditures are allocated consistently, which is depreciation (Yang, 2014). Thus, it will result in more constant earnings, hence it can increase the ability to predict the future earnings. However, the question is whether capital expenditures spent by firm really give minimum degree of uncertainty?

Basically, all of the investment options contain some risks related with its uncertainty in the future. Thus, it can be stated that every investment taken by the firms is potential to contribute in the fluctuation of earnings and create uncertainty of future earnings, and so is capital investment. Hansen and Mowen (2006, p. 754) argued capital investment decision will use large amount of resources at risk for long-term periods of time and simultaneously affect future development of the firm. So, the decision is very critical for the firms. It is also important to choose the proper capital investment in order to maintain or enhance its long-run profitability, since it relates with firms' operational activities and profit. If firm can choose right capital investment, it will help in sustaining its profitability; therefore reduce the uncertainty of future earnings.

Moreover, sometimes the firm does not select the right investment, because of its difficulties. It relates with the future; that obviously deals with uncertainty and the estimation also takes place. So, if the manager has wrong estimation, it causes him/her as decision makers can occasionally spend capital expenditures to an ineffective, un-productive and non-profitable investment. Instead of supporting their operation, those un-prospective investments will give negative impact to the firm itself and also result in the higher degree of uncertainty of future earnings.

Investment decision is also related with the opportunity growth of the firm. When the firm has opportunity growth they will acquire more assets. In other words, they try to achieve its growth as well as its profitability through an appropriate investment. Firm's growth opportunity is measured by investment opportunity set. Investment opportunity set has long been acknowledged to show the growth option of firms through the valuable investment opportunity that they have. It is found that the higher the investment opportunity set will be followed by increasing of the total investment (Richardson 2006; Biddle et al. 2009; as quoted by Ramalingegowda et al. 2013). Furthermore, Mcguire et al. (2014) also found greater investment opportunities are likely associated with a lower probability that a firm will invest in non-profit oriented investment (e.g. tax shelter activity). Thus, firms with high investment opportunity sets tend to invest in prospective investment. Prospective investments contain less degree of uncertainty compare with other investments. Hence, by choosing the prospective investment, the uncertainty of future earnings can be decreased.

However, sometimes the firm behaves in the opposite way. Since, greater investment opportunities create more complex information environments, and selecting investment options depends on managers' discretionary spending choices, which are difficult to predict and monitor by external parties (Smith and Watts 1992; Cahan et al. 2008; as quoted by Mcguire et al. 2014). So, if the manager does not have those kinds of expertise to choose the investment carefully, it also can result in the wrong investment. Moreover, because of such opportunity, the firm tends to mislead the opportunity by selecting investment which is un-useful investment and not give any value added or benefit towards the firm. In addition, Atmaja (2013) stated that the firm can misuse in using the fund to the speculative projects, instead of prospective investment. Free cash flow theory also supports this premise. This theory states that firms with large sums of free cash flow have incentive to overinvest. They might invest in less profitable ventures because they move outside their area of expertise (Vermeulen and Smit 2011).

The role of investment opportunity set is being arguable whether it encourage firm to invest in more prospective project, or vise versa. If the investment opportunity set encourage firm to invest in more prospective investment, it will able to reduce the effect of capital investment towards the uncertainty of future earnings. Unfortunately, those relationships have not examined yet. It is the reason why this research tries to examine the relationship among capital expenditure, IOS, and uncertainty of future earnings. Moreover, this paper will be able to reveal the firms' investment behavior in Indonesia whether the firms are careful and wise enough in spending their capital expenditures. It also assures, firm whose opportunity growth is high, do not mislead the fund that will harm the investors or other external parties.

1.2. Research questions

The investment decision is very difficult, since it involves estimation of future that related with uncertainty (Hansen and Mowen 2006). Thus, the return of investment cannot be assured. It makes the nature of capital investment also contain risk. This risk can be reduced by choosing prospective investment. If firms can use the capital expenditures wisely through prospective investments, it will reduce the uncertainty of its future earnings. In addition, if the firm chooses wrong investment, it will lead to higher degree of uncertainty of future earnings. The Investment Opportunity Set which shows the growth opportunity of the firm is questioned whether it can encourage firm to invest in the prospective investment. Therefore, the question in this research is formulated as:

1. Do capital expenditures positively affect the uncertainty of future earnings?
2. Does IOS have moderating effect by mitigating the relationship between capital expenditure and uncertainty of future earnings?

2.3.Research objectives

The objective of this research is to prove empirically:

1. The positive impact of capital expenditures to the uncertainty of future earnings
2. The role of Investment Opportunity Sets which can mitigate the relationship between capital expenditures and uncertainty of future earnings.

2.4.Research contributions

This research is expected to contribute in some aspects:

1. Academic

   This research can be used as new literature in examining the uncertainty of future earnings, as well as can be used as a reference for next research.

2. Practical

   The investors can use this research as consideration to decide the proper firm that they will invest in. The result also can be used to know the firms' investment behavior.

3. Policy

   It can be used as the input by Indonesian firms to make investment decision carefully. Therefore, they can maintain its growth as well as the certainty of earnings.

2.5.Data Analysis

In doing this research, some steps are performed to find the reliable result. They are:

1. Data collection

   The secondary data is used in form of financial report and share price of the manufacturing firms that is listed in Indonesian Stock Exchange (IDX) from 2005 until 2013. The data is taken from Kantor Bursa Efek Indonesia at Mangkubumi Street 111, Yogyakarta and/or downloaded from www.idx.co.id and www.yahoofinance.com.

2. Measurement of each variable

   Each variable will be calculated by the determined measurements.

   a. Uncertainty of future earnings is calculated by using the standard deviation of future operating income per share deflated by share price in the beginning period.
   b. Capital expenditures is measured by the current spending of capital expenditure relatively to lagged market value of equity.
   c. Investment opportunity sets is calculated by using Tobin's q.

3. Classical assumption tests

   This test includes the normality test, which is done to test the normality of the data. It used Kolmogorov-Smirnov test in the SPSS software. Moreover, classical assumption tests are done to get the fit regression model which is free from autocolleration, heteroscedasticity, and multicollinearity.

4. Multiple regression analysis

   This test is performed to answer the research question by finding the result.

2.6. Writing Structure

This paper is organized as follows:

CHAPTER 1 INTRODUCTION

Chapter 1 will contain the background, problem, objectives, and how this research can give contribution in some aspects.

CHAPTER 2 LITERATURE REVIEWS AND HYPOTHESIS DEVELOPMENT

It will show the theoretical background and previous research that support this research and also be used as a basis in formulating the hypothesis development.

CHAPTER 3 RESEARCH METHODOLOGY

It includes research design (data collection, sample, definition and measurement of variables) as well as all of the required tests to get the reliable result.

CHAPTER 4 DATA ANALYSIS AND DISCUSSION

In this chapter the result of the tests will be presented and analyzed to find the conclusion.

CHAPTER 5 CONCLUSION

It covers the conclusion and limitations of the research, along with the suggestion for the next research.