

## **CHAPTER II**

### **LITERATURE REVIEW**

This chapter will explain the elaboration of the concepts of the variables to be studied regarding the Capital Market, Profitability (Return on Assets), Asset Tangibility, Firm Size and Leverage.

#### **2.1 Literature Review**

##### **2.1.1 Capital Structure Theories**

It is argued that in a perfect market, a company's capital structure does not matter because the value of the company is based on its earning power and its risk (Neves et al. (2020)). Values can be derived regardless of the way in which they are financed or how they are invested. There are two propositions: 1) A company's capital structure has no impact on its value. In an identical firm, the value is the same regardless of the method of financing to finance the assets. Companies are valued according to their expected future earnings. Taxes do not affect the value of the firm. 2) When a firm has financial leverage, its value increases and the WACC decreases. The tax information is used to determine these benefits. In response to the theory, the firm's value will be maximized in the situation where the firm uses 100% debt. Based on this theory, few other theories emerged, such as the trade-off theory, pecking-order theory, agency cost theory and the market timing theory.

##### **1. Trade-Off Theory**

The initial theory of the trade-off theory appeared after the controversy on the theory of Modigliani-Miller. 100% debt usage is unobtainable. In reality, the bigger the debt a firm has, the higher of a burden that must be borne by the firm itself. Its agency costs, bankruptcy cost, creditors' reluctance to give large debts are the factors that needed to be considered. In addition to the theory proposed by Modigliani-Miller, the corporate income tax provides an advantage for debt, which means the earnings are shielded from taxes. Several alternatives of leverage plans are

analyzed and evaluated by the firm manager. In most cases, the trade-off theory is expected to obtain an interior solution to strike a balance between marginal costs and benefits. (Ahmadimousaabad et al, 2013). The implication for the trade-off theory are as following:

1. The use of debt by companies with large business risks must be reduced compared to those with low business risks, because the greater the business risk, the greater the interest expense, which will impact the financial health of the company.
  2. In some cases, companies with high taxes should employ a lot of debt due to the tax shield
  3. Each company will have a different target debt ratio. The target debt ratio of profitable companies and companies with tangible assets is higher. Intangible assets and high risk companies have lower debt ratios and rely more on equity.
2. Pecking-Order Theory

Another theory being one of the most influential theories of corporate leverage is the pecking order theory. Neves et al. (2020) stated that the pecking order theory is a structure in which companies prefer to use internal equity to pay dividends and promote growth as a means to raise funds. External debt is preferred prior to external equity if companies need external funds. To simplify this, suppose that three sources of funding that are being used commonly, which are the retained earnings, debt and equity. The retention of earnings does not lead to adverse selection. Debt, on the other hand, has only a minor adverse selection problem compared to equity. A riskier investment, from the standpoint of an outside investor, is equity. There is an adverse selection risk premium on both, but it is much higher on equity than it is on debt. An investor outside of the company will therefore demand a higher return on equity than on debt. Retained earnings prove to be a better source of funding for those inside the company than are debts,

and debt offers a better deal than equity financing. Thus, all projects will be financed using retained earnings if possible. The company will use debt financing if retained earnings are inadequate. Accordingly, a company in normal operation won't use equity and its financing deficit will be equal to its net debt. There are orders in funding in correlation to pecking order theory, which are stated as following:

1. Companies prefers internal financing
  2. Firms adjust their target dividend payout ratio to their investment opportunities, while avoiding drastic dividend changes
  3. A “sticky” dividend policy plus unpredictable fluctuations in profitability and investment opportunities means that sometimes internal cash flow exceeds investment requirements but sometimes falls short of investment requirements.
  4. If external funding is needed, the company will first issue the safest securities, namely starting with the issuance of bonds (debt), convertible bonds, the last alternative is securities.
3. Agency Theory

According to agency theory, firms are confronted with problems as a result of separation between owners and managers. It places emphasis on the reduction of this problem. It provides a framework for implementing various governance mechanisms in jointly held corporations to control agents' actions (Panda & Leepsa, 2017). The most popular agency theory described that the principal and the agent formed some kind of agency relationship whereas both work for self-interests which climaxed at the conflict of agency (Neves et al., 2020). They also defined firm as a “black box” meaning that it is to maximize its profitability. It is possible to maximize wealth through effective coordination and teamwork between the parties involved in the firm. However, these interests differ, resulting in conflict of interest, which can only be addressed by managerial ownership

and control. As self-interested parties, they knew their interest could only be served by the existence of the firm. Thus, they act in the interests of the firm.

#### 4. Market Timing Theory

According to Neves et al. (2020), Equity market timing is defined as the action of issuing shares when it is on its peak and repurchasing when the prices dropped. Companies issue equity when the timing and market seem to be most favorable based on the current state of both debt and stock markets.

##### 2.1.2 Profitability (Return on Asset)

Profitability is defined as a ratio that measures the performance of a firm managing its own resources (Rahayu & Bida, 2018). Its profit increases linearly with the firm value during the process of optimizing assets usage, boosting its sales and cost efficiency. Higher profitability ratio leads to the asset productivity in generating incomes (Putri, 2020). According to Heri (2015), profitability ratio represents the ability of a firm's performance upon generating profit. The ratio is divided to:

1. The rate on investment ratio. It is the ratio used to assess compensation for the use of assets or equity against net income. Return on Asset (ROA) and Return on Equity (ROE) are the described ratio.
2. Operating performance ratio is a ratio used to evaluate profit margins from operating activities (sales). The ratios are: Gross Profit Margin, Gross Profit Operational, and Net Profit Margin

Heri (2015) stated that Return On Asset is defined as a ratio to show the portion of contribution to asset upon generating net profit. This indicates that this ratio is used to measure how much net profit will be generated from each rupiah of funds embedded in total assets. The greater the ROA, the greater the level of profit achieved by the company and the better the position of the company in terms of the

use of assets. (Wijaya, 2019). According to Neves et al. (2020), the equation of Return On Asset is as following:

$$\text{Return On Asset} = \frac{\text{Earning Before Interest and Tax (EBIT)}}{\text{Total Assets}}$$

### 2.1.3 Asset Tangibility

Asset Tangibility is defined to be related to amount of asset which can be converted to collateral in order to reduce the risk for the creditor. The bigger the portion, the more credible the firm to be receiving funds which leads to bigger debt (Antao & Bonfim, 2012). Essentially, asset tangibility refers to how much collateral a company can offer to its creditors. Creditors have more security in the event of bankruptcy when fixed assets represent a high percentage of total assets. As soon as the business has been dissolved, tangible assets can be offered as collateral to creditors in the event of bankruptcy, such as land, buildings, machinery, and construction in progress. According to Neves et al. (2020), the equation of Asset Tangibility is as following:

$$\text{Asset Tangibility} = \frac{\text{Tangible Fixed Assets}}{\text{Total Assets}}$$

### 2.1.4 Firm Size

According to Jaya (2020), a firm's size can be determined from its revenue and total assets which is based on the financial report or the amount of labor. It is a standard for the company which can be overlooked from the total assets every ending period of the year. The total sales obtained can also be used as a benchmark to measure the size of the company. With a large level of sales, it indicates that the company has large capital and assets so that it can support production process activities on a large scale. So with a large level of sales, it can certainly affect the value of a company. Large companies tend to need a good image in order to get

relations or investors. The larger the company can provide the assumption that the company is known by the wider community so that it is easier to increase the value of the company. Company size is one of the factors that determine the company's ability to generate profits. According to Neves et al. (2020), the equation of Firm Size is as following:

$$Firm\ Size = \ln(total\ assets)$$

### 2.1.5 Leverage (Debt to Asset)

According to Kasmir (2012), Debt to Asset is defined as debt used to measure the ratio between total debt and total assets. Debt to assets ratio provides information about the company's ability to adapt to conditions of reduced assets due to losses without reducing interest payments to creditors. A high ratio value indicates an increase in risk to creditors in the form of the company's inability to pay all its obligations (Mahendra, 2015). According to Neves et al. (2020), the equation of Leverage is as following:

$$Leverage = \frac{Total\ Debt}{Total\ Assets}$$

## 2.2 Research Model

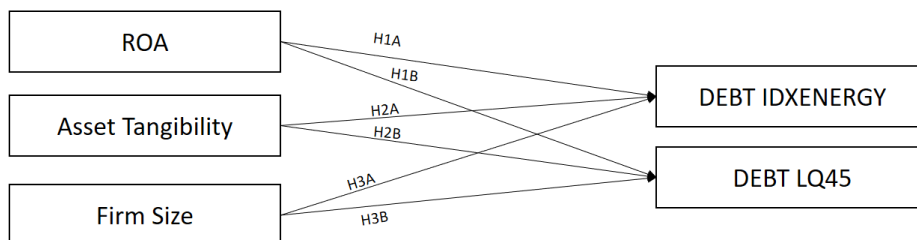




Figure 2.1 Research Model

## 2.3 Hypothesis

### 2.3.1 Profitability Impact on Overall Leverage

According to Neves et al. (2020), profitability which is defined as Return on Asset, has negative and significant relationship towards the overall leverage which is defined as debt to asset. The impact is the same among large enterprises and SMEs in the Portuguese capital market. Self-financing is seemed preferable for large enterprises, resulting in lower need for external debt. The reason for this is that the most profitable companies have a high level of self-financing capacity, so they are not dependent on external financing. This research is in line with the pecking order theory. Some other researches such as Alipour et al. (2015), Acarravci (2014) and Ramjee & Gwatidzo (2012) also implicates that there is negative and significant relationship.

However, a research conducted by Akinyomi & Olagunju (2013) stated that there is a positive but insignificant relation for the firms in Nigeria. This is in line with the trade-off theory where firms in Nigeria whose debt are used more are more profitable. Also, an insignificant relation is found on the research conducted by Ab Wahab and Ramli (2014). From these past researches, the research proposed the hypothesis as:

H<sub>1A</sub> : Profitability has a significant impact on Overall Leverage of firms listed on the IDXENERGY

H<sub>01A</sub> : Profitability has no significant impact on Overall Leverage of firms listed on the IDXENERGY

H<sub>1B</sub> : Profitability has a significant impact on Overall Leverage of firms listed on the LQ45 which excluded the same firm listed in IDXENERGY

H<sub>01B</sub> : Profitability has a significant impact on Overall Leverage of firms listed on the LQ45 which excluded the same firm listed in IDXENERGY

### **2.3.2 Asset Tangibility Impact on Overall Leverage**

According to Neves et al. (2020), Asset Tangibility for larger enterprises and SMEs has significant and positive relationship on Overall Leverage. Large firms tend to have a higher level of tangible fixed assets, resulting in better accessibility to external financing sources and able to secure debts with the assets in a situation of bankruptcy. And for smaller firms, tangible fixed assets are utilized as collaterals to acquire debt. This research is in line with the trade-off and pecking order theory. Some other researches such as Akinyomi & Olagunju (2013), Ramjee & Gwatidzo (2012), and Saif-Alyousfi et al. (2020) also stated that the impact is positive and significantly related.

However, a research from Acarravci (2014) using Turkish as the object specifically its Manufacturing Sector found out that the impact is negative, but still on the significant relationship. From these past researches, the research proposed the hypothesis as:

H<sub>2A</sub> : Asset Tangibility has a significant impact on Overall Leverage of firms listed on the IDXENERGY

H<sub>02A</sub> : Asset Tangibility has no significant impact on Overall Leverage of firms listed on the IDXENERGY

H<sub>2B</sub> : Asset Tangibility has a significant impact on Overall Leverage of firms listed on the LQ45 which excluded the same firm listed in IDXENERGY

H<sub>02B</sub> : Asset Tangibility has no significant impact on Overall Leverage of firms listed on the LQ45 which excluded the same firm listed in IDXENERGY

### **2.3.3 Firm Size Impact on Overall Leverage**

According to Neves et al. (2020), Firm Size on larger enterprises is not significantly related in the statistical result. In contrary, for SMEs, there is a positive and significant relationship. For larger firms, it is mentioned that only short term



debt is significantly related and has negative relationship, which implicates that for the overall debt and long term debt have insignificant relationship. For SMEs, increasing company size leads to greater diversification of activities, greater transparency, and more reliable information that reduces risk and bankruptcy costs. This encourages companies to raise their debt level. It is in line with the trade-off theory. Another research from Ramjee & Gwatidzo (2012), stated that the impact of the research is positive and significantly related. This is likely due to the relation of larger firms are likely to default which means they have larger base asset. Research from Acarravci (2014), Alipour et al. (2015), Akinyomi & Olagunju (2013) found out that the impact is negative. However, the significances are different in the research mentioned. Which Acarravci (2014) found out the impact are significant, while Alipour et al. (2015) did not state the significance and Akinyomi & Olagunju (2013), found out that the impact is insignificant. From these past researches, the research proposed the hypothesis as:

H<sub>3A</sub>: Firm Size has a significant impact on Overall Leverage of firms listed on the IDXENERGY

H<sub>03A</sub>: Firm Size has no significant impact on Overall Leverage of firms listed on the IDXENERGY

H<sub>3B</sub>: Firm Size has a significant impact on Overall Leverage of firms listed on the LQ45 which excluded the same firm listed in IDXENERGY

H<sub>03B</sub>: Firm Size has a significant impact on Overall Leverage of firms listed on the LQ45 which excluded the same firm listed in IDXENERGY

U N I V E R S I T A S  
M U L T I M E D I A  
N U S A N T A R A