CHAPTER II

LITERATURE REVIEW

2.1 Capital Market

Capital market is a market for securities (debt or equity), where business enterprises (companies) and governments can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets (e.g. the money market) (*Sullivan and Sheffrin*,2003). Capital Market Law Number 8 Year 1995 defines Capital Market as "the activity of trading and offering securities to the public, the activity of a public company with respect to securities it has issued, and the activities of securities-related institutions and professions." Capital markets may be classified as primary markets and secondary markets.

Primary market is the part of the capital markets that deals with the issuance of new securities. In primary markets, new stock or bond issues are sold to investors by a mechanism known as underwriting. Underwriting is the process that a large financial service provider (bank, insurance, investment house) uses to assess the eligibility of a customer to receive their products (equity capital, insurance, mortgage, or credit).

Secondary market is the financial market which is previously issued financial instruments such as stock, bonds, options, and futures are bought and sold. In the secondary markets, existing securities are sold and bought among investors or traders, usually on a securities exchange, over-the-counter, or elsewhere.

Capital Market plays an important role in the economy of a country because it serves two functions all at once. First, Capital Market serves as an alternative for a company's capital resources. The capital gained from the public offering can be used for the company's business development, expansion, and so on. Second, Capital Market serves as an alternative for public investment. People could invest their money according to their preferred returns and risk characteristics of each instrument.

2.1.1 Capital Market in Indonesia

The stock trading in Indonesia has already existed since the colonial period, when Indonesia was named Hindia Belanda. The securities trading in Batavia (now named as Jakarta) was started on December 14th 1912, in Surabaya started on January 11th 1925, and in Semarang on August 1st 1925. The securities trading activities was closed when the second World War happens. On that time, the trading securities had not organized. That's why it is hard to find the historical data of securities trading from that time.

According to Koetin (1997), the securities trading activities are very high, because it involves about 250 securities instrument which is consists of stock, obligation, and foreign Depository Receipt. The perpetrators of security trading on colonial period are mostly the Dutch, the Arabian, and the Chinese.

Based on the information that given by IDXs' website, after Indonesia got its' independence, the government is issuing Regulation Number 15 year 1952 about the stock exchange. The main factor to re-open the stock exchange is to control the 3% Indonesian Obligation (ORI 3%) year 1950. The trading activity was controlled by *Perserikatan Perdagangan Uang dan Efek (PPUE)* which started from November 1st 1951. Unfortunately, the economic condition was falling along with the decline of political and security situation at that time until year 1965.

In 1965, Mr. Soeharto became the president of Indonesia's Republic. Under the leadership of Mr.Soeharto, the government started to use the open economic system by issuing Regulation of Foreign Assets Investment on 1967, and also Regulation of Domestic Assets Investment on 1968. In ten years after those regulation had been issued, Indonesia's economy situation got rising. Thus, in August 10th 1977 the stock exchange activity is reactivated by the opening of Jakarta Stock Exchange (JSX).

2.1.2 Financial Instrument in IDX

The "goods" that is sold in IDX is called as financial instruments. Financial instruments traded in the capital market are the long term securities (a period of more than 1 year). They consist of stocks, bonds, warrants, rights, mutual funds, and other derivative instruments (options, futures, etc.).

According to IDX, a bond is an instrument in which the issuer (debt or borrower) promises to repay to the lender/investor the amount borrowed (principal) plus interest (coupon) over some specified period of time. The issuer may be a corporation or government. The interest is usually paid at specified intervals, such as semi-annually or quarterly. When the bond matures, the investor receives the entire amount invested, or the principal plus coupon. Once issued, bonds can be traded like any other securitya before its mature without paying penalty which is unlike in average time deposit (ATD).

Stated by IDX, Derivative Security is a financial security whose value is derived from the value of another security (underlying asset) such as equity or debt instrument. It can derive directly from an underlying asset or from the underlying asset's derivatives. Derivative can also be defined as a contract or agreement, which value depends on the performance of an underlying asset. In a more specific definition, derivative is a traded financial contract between two or more parties to buy or sold an asset/commodity on an agreed time and price. The future value of the derivative is highly influenced by its underlying asset in the Spot Market.

Generally, Mutual Fund is defined as a mean to collect fund from the investment society to be invested in portfolios by the fund manager. This definition is also written in the Capital Market Law No.8/1995 section 1 clause (27) regarding Mutual Fund. There are three points shown on this statement. Firstly, Mutual Fund collects fund from the society. Secondly, the fund is then invested in the securities portfolio. Third, the fund is managed by an Investment manager.

ETF or Exchange Traded Fund can simply be defined as mutual fund traded in the Exchange. Just like mutual fund, ETF is a Collective Investment

Contract, but similar to shares, its investment unit is listed and traded in the Exchange. Like conventional mutual fund, ETF also uses an Investment Manager and Custodian Bank. One type of ETF developed in the Indonesia's Capital Market is the Index Mutual fund, where the underlying index used is the LQ45 index.

In this research, the stocks is becoming the main source of the topic that will be discussed. Thus, we will discuss further about the stocks in the next sub discussion.

2.2 Stock

Share is one of the most popular securities available. If a company wants to raise capital, one of its options is to issue stock. Stock also offers interesting return rate for its investors. That is why most investors choose stock for their investment. Stock can be defined as a sign of ownership of an individual or institution in a corporation. The person or institution who owns the stock can claim on the company's earnings, assets, and rights to attend its General Meeting of Shareholders. Basically, there are two benefits for stock investors:

a. Dividend

Dividend is the earning given to the company's shareholders from the company's income. The amount of dividend paid to the shareholders is decided in the Company's Annual General Meeting. To receive dividend, a buyer of a stock must own the stock for a relatively long period until it passes its ex-dividend date, where he/she will be acknowledged as the shareholder who has the right to obtain the dividend.

b. Capital Gain

Capital gain is the positive different between the purchase price and the selling price of a stock. Capital gain is formed through the stock trading activities in the secondary market. For example, an investor bought ABC’s stock for Rp 3,000 per share and then sold it for Rp 3,500 per share. It means the investor receive capital gain of Rp 500 for every sold share.

However, like other instruments of investment, stock has its own risks. According to IDX there are two risks on stocks. They are :

a. Capital Loss

It is the reverse of Capital Gain. It is a condition when the stock is sold for a price that is lower than its original purchase price. For instance, an investor bought the stock of PT XYZ for Rp 2,000 per share, but aftermath the stock price fell to the level of Rp 1,400 per share. Afraid of continuous declines, the investor sells the shares for Rp 1,400 per share. The investor has retained a capital loss of Rp 600 per share.

b. Liquidity Risk

A Company, whose shares are owned by public, is stated for bankruptcy by the Court or is being dismissed. In this case, the claim of the shareholders' rights will get the last priority after all the company’s liabilities have been settled (through the selling the company’s assets). The rest of the company’s wealth, if exist, will be distributed proportionally to the shareholders. However, if there is no rest left, the shareholders will not receive anything. This is the worst condition a shareholder might go through. Thus, a shareholder needs to monitor every development happens in the company.

In the secondary market or daily stock trading, stock price fluctuates. Stock price is formed by the demand and supply of the stock, while the supply and demand of a stock are influenced by many factors, such as the company and industry's performance, the macro factors (interest rate, inflation, currency rate), the non-economical factors (social and political conditions), and so on.

2.3. Financial Report

2.3.1. Introduction of Financial Report

Every company has to provide financial report in order to give financial information which used to external and internal party who need financial report to make some decision. The definition of financial report is explored by Weygandt at al. (2007:2). According to Weygandt at al. (2007:2) in the book of Intermediate Accounting explain that "Financial reports are the principal means through which a company communicates its financial information to those outside it. These statements provide a company's history quantified in money terms. The financial reports most frequently provided are (1) the balance sheet, (2) the income statements, (3) the statement of cash flows, and (4) the statement of owners' or stockholders' equity. Note disclosures are an integral part of each financial report.".

Stated by Peterson (1999), financial report is the collection and presentation of current and historical financial information. Financial report should be concerned with presenting the economic history of specific economics entities and that it is the best done when managements also are willing to disclose and discuss their strategies, proposed tactics and plans, and expected outcomes (Financial Accounting Policy Committee, 1993).

According to Sundjaja & Barlian (2001:47), financial report is the statement which describes the result of accounting process that used as the communication devices between financial data of company and related party.

Conclusions for the statement above about the fundamental of financial report is the historical financial information that provide from the management to connect the financial data of company and the related party.

2.3.2. Types of Financial Report

According to Indonesia Accounting Standard (IAI), Financial report is the organized statement from financial position and financial effort of certain entity. The purpose of financial report is giving the information about financial position, financial effort, and cash flows that useful to parties who need the financial report for certain purposed. In order to achieve the objective, financial report has responsibility to provide the information that involve:

1. Balance Sheet

It is the part of financial report that gives some information about financial position of company in certain period. In balance sheet, having several data must be fulfilled to describe financial position in certain period. Those data are:

a. Assets

According to Financial Accounting Standard Board (FASB) paragraph 25 stated that Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. It means to claim that is the company assets, having three requirements that have to be fulfilled. First, it must be controlled by the company. Second, it must be benefit for the future. Third, it is owned by the company. Based on type of asset, having three types of asset. First, it is current assets (Cash, Receivable, Inventory). Second, it is fix assets (Land, Building, Vehicle, Machines, Equipment). Third, it is intangible asset (Goodwill, brand, license).

b. Liability

Based on Financial report Standard Board (FASB) in paragraph 35 stated that Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. Based on the time, liability divided into two categories, short-term liability (account payable, salary payable, tax payable) and long-term liability (obligation debt).

c. Owner's Equity

it is part of owners right in company that can be traced with calculating the total asset deducted by the total liability. In owner's equity, internal and external parties can trace the equity that getting from the owners (Stock) and equity that getting from operational result (Dividend and Retained Earnings).

2. Income Statement

It is part of financial report that gives the information about the ability of the company to get some profit in certain period. Differences between the total revenue and total expenses called by profits/losses. For the explanation, it will be provided in explanation below:

a. Revenue

Based on Australia Accounting Standard Board (AASB, 1998:22) stated that revenues means inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the financial year.

b. Expenses

Based on Australia Accounting Standard Board (AASB, 1998:20) stated that expenses means consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners that result in a decrease in equity during the financial year.

3. Cash Flows

It is the part of financial report that provides the information about where the cash of the company go and obtain.

2.3.3. Objectives of Financial Report

Based on Government Accounting Standard (GAS, 2005:9) stated that the objectives of the financial report is providing the information towards financial position, budget realization, cash flows, and financial performance in report entity giving benefit to the stockholder in making and evaluating the decision that is related to the decision making and to show the reporting entity of accountability based on the resource that is trusted on him/her.

2. 4 Financial Ratio Analysis

According to Keown (2002;63), financial ratios is restating the accounting data in relative terms to identify some of the financial strengths and weaknesses of a company. The financial ratios analysis is the technique of analysis that is commonly used to evaluate the financial condition and achievement of the company.

Stated by Munawir in Mahardhika (2011), the ratio is number or percentage that shows the relation between several variable with other variable. The ratio will depicts a condition or the financial position of a company and also to shows the areas that needs attention to fix.

Based on the definition above, we can conclude that the analysis of financial ratio is a tool for knowing the condition of company's financial aspect, to evaluate the previous condition and giving an "image" of the future financial condition of the company itself. For the result of analysis, it depends on the ability of the analyzer.

2.4.1 Types of financial report ratio

According to Brigham and Houston in Mahardhika (2011), the financial ratios can be divided into four categories, those are :

1. Liquidity

A ratio showing the company's ability in fulfill their short term liabilities. The higher of the liquidity ratio, the better the company's ability to fulfill their short term liabilities. According to Keown (2002;64), there are two ways in assessing the liquidity ratio. First, we can look at the firm's assets that are relatively liquid in nature and compare them to the amount of the debt coming due in the near term. Second, we can look at how quickly the firm's liquid assets are being converted into cash. For example, the cash ratio (CR), quick ratio (QR), and current ratio. For this research object, the Author uses current ratio to assess the liquidity ability.

According to Keown (2002;65), the current ratios indicates a firm's liquidity, as measured by its liquidity assets (current assets) relative to its liquid debt (short-term or current liabilities). Thus, we could use the following calculation to estimate a company's relative liquidity :

$$Current\ Ratio = \frac{Current\ Assets}{Current\ Liabilities}$$

2. Solvency (Leverage)

The ability of the company to meet its financial obligations when the company's financial obligations have been liquidated, both short and long term. A company having a low level in leverage ratio also has low level in looses risk, but it also has the low level of return. For example debt to equity ratio (DER), debt to total asset ratio (DAR). For this research object, the Author uses debt to equity ratio (DER) to asess the solvency ability.

According to investopedia, DER is a measure of a company's financial leverage calculated by dividing its total liabilities by stock holders equity. Indicates what proportion of equity and debt the company is using to finance its assets.

$$DER = \frac{Total\ Liabilities}{Shareholders\ Equity}$$

Information :

Total liabilities : total of liabilities that must be paid by the company to the third party (including the short term and long term)

Shareholders equity : the residual right of the company's asset after reduced by the all liabilities.

3. Profitability

The ability of the company to generate profits during the given period. This ratio is used to asess the managerial level in manage the company that's shown with the total income (from selling and investing). The examples of profitability ratio are gross profit margin (GPM), operating profit margin (OPM), net profit margin (NPM), return to total asset (ROA), and return on equity (ROE). For this ratio, the Author id using the ROA , ROE, and NPM ratio to asess the profitability of company.

The return on asset (ROA) level is calculating the whole efectivity in earning gain through the available assets. The formula for this ratio is :

$$ROA = \frac{Net\ Income}{Total\ Assets}$$

Information :

Net Income : The differences between total income for a period and the total cost.

Total Assets : Current assets and fixed assets that used for the short and long term.

The return on equity (ROE) level is calculating the ability in earning gain to the book value of stock. The formula for this ratio is :

$$ROE = \frac{Net\ Income}{Stockholders\ Equity}$$

Information :

Net Income : The differences between total income for a period and the total cost.

Stockholders equity : The residual right for the company's assets after reducing by its liabilities.

Net profit margin (NPM) asess the profitability ratio related to the selling income. The formula for this ratio is :

$$NPM = \frac{Net\ Income}{Net\ Selling}$$

Information :

Net Income : the differences between total income that earned during a period with the total cost.

4. Turnover Ratio

Turnover ratio is used to asess the company's ability in manage their assets thus it can gives cash flow to the company. The example of this ratio is inventory turnover ratio, fixed assets turnover ratio, total assets ratio.

5. Market Ratio

Generally, financial ratios consist of liquidity ratios, activity ratios, leverage ratios and profitability ratios, and profitability ratios. There is one more ratio that can be used to measure the performance of a company's financial reports, called the market ratios.

This ratio is an indicator to measure the price of a stock, the size of the achievements of the company for shareholders, as well as assist investors in finding stocks that have great profit potential dividends before investing in stocks. But this ratio can not indicates the efficiency level of ratio and the ratio can not reflect the company's overall financial performance by the stock price point of view if it is used by the management in a company.

Market ratio is the ratio connecting the stock prices with earnings and book value per share. This ratio gives a clue about the invenstor opinion for the performance of companies in the past and future prospects (Moeljadi, 2006:75). This ratio provides information about the size of people (investors) or the company's shareholder interest to the company, so they want to buy the company stock with higher price than the book value of shares (Sutrisno, 2003:256).

2.5 Previous Research

This research is aimed to continue the previous research that has been done by Sasongko (2002), Antara and Lestari (2005), Limbong (2006), Hijriah (2007), Nurmalasari (2008), Simanungkalit (2009), Rinati (2009), Hidayat (2009), Mahardhika (2011), Lindayati (2011), Yudistira (2011).

1. Sasongko (2002), *"Pengaruh EVA dan Rasio-Rasio Profitabilitas Terhadap Harga Saham"*. The aim of this research is knowing the effect of EVA and profitability ratio to the stock's price of manufacture company that lists in IDX. The research objects is the manufactures company that lists in IDX for year 2001 – 2002. The method that used is multiple regression method. The result from this research is the Return on Assets (ROA), Return on Equity (ROE), Return on Stock (ROS), Break Even Point (BEP), and Earning Value Assets (EVA) are not giving any effect to the stock's price. While the Earning Per Share (EPS) is influencing the stock's price.
2. Antara and Lestari (2005), *"Faktor- Faktor yang Mempengaruhi Kinerja Saham Perusahaan Agribisnis di BEJ"*. The aim of this research is to knowing are the EPS, NPM, PER, ROI, and ROE giving any influences to the stock's price. This research object is the agriculture companies in IDX year 2001 – 2004. The method that used is purposive method. The result

from this research is the EPS, NPM, PER, ROI, and ROE are simultaneous influencing the stock's price.

3. Limbong (2006), *"Analisis Faktor Fundamental dan Risiko Sistematik Terhadap Tingkat Keuntungan Saham Perbankan di BEJ"*. The aim of this research is to knowing the effect from fundamental ractor and sistematics ratio to the stock's price. In this research, they are using the logistic regression method. The research object are the banking company in IDX. The result of this research are :

- The fundamental factor and systematic risk is influence to the stock;s price of the company in simultaneous.
- In partial, the fundamental factor (RORA, NPM, and LDR) is significant influence to the company's income.

4. Hijriah (2007), *"Pengaruh Faktor Fundamental dan Risiko Sitematis Terhadap Harga Saham Properti di BEJ"*. The aim of this research is to find out the effect of the fundamental factor and sistematic risks to the stock's price of the property companies that listed in IDX for year 2002-2006. The research object of this research is the property companies that listed in IDX for year 2002-2006. This research is using explanatory description method. The result of this research are :

- ROE, PER, and BV is partialy influence to the stock's price
- ROA, ROE, DER, PER, EPS, and BV is significantly influence the stock's price.

5. Nurmalasari (2005), *"Analisis Pengaruh Rasio Profitabilitas Terhadap Harga Saham Emiten LQ45 yang Terdaftar di BEI Tahun 2005-2008*. The aim of this research is to find out are the ROA, ROE, NPM, and EPS is influence to the stock's price of the LQ45's companies. The object of this research is the companies that listed in LQ45 of IDX year 2005-2008. The method that used is multiple linear method. The result of this research are :

- ROA, ROE, NPM, and EPS is influincing the stock's price.
- ROA is influincing the stock's price in partially.

6. Simanungkalit (2009), *"Pengaruh Profitabilitas dan Rasio Leverage Keuangan Terhadap Return Saham Pada Perusahaan Makanan dan Minuman Terbuka di Indonesia"*. The aim of this research is to find out the effect from the profitability and leverage ratio in beverage companyies stock's price for year 2004-2007 that listing on IDX. The object of this research is beverage companyies stock's price for year 2004-2007 that listing on IDX. In this research, they are using double multiple regression method. The result of this research are :

- The ROA, ROE, and DTA is assembly giving the significant influence to the stock's return
- The ROA is not influence the stock's return
- ROE is having significant influence to the stock's price
- DTA is not influence the stock's price

7. Hidayat (2009) "*Pengaruh Rasio Keuangan Terhadap Return Saham Pada Perusahaan yang Terdaftar di Bursa Eefek Indonesia"*. The aim of this

research is to testing and analizing the effect of solvability ratio, profitability ratio, liquidity ratio, activity ratio, and market ratio to the return of stocks that lists in IDX. Those ratio are involve by current ratio (CR), debt to equity ratio (DER), leverage ratio (LEV), net profit margin ratio (NPM), return on assets (ROA), return on equity (ROE), earning per share (EPS), total assets turnover (TATO), price to earnings ratio (PER), price to book value (PBV). This research is taking all of the issuer that listing in IDX from year 2004-2007 with total population 325 issuer. The analysis technique that used by this author is linear regression approach. The result of this research are the liquidity and solvability ratio is not significant in influencing the stocks price, and the second result is the profitability ratio, activity ratio, market ratio, and financial ratio are influencing simultaneous to the price stocks.

8. Rinati (2009), *"Pengaruh NPM, ROA, dan ROE Terhadap Harga Saham Pada Perusahaan yang Tercantum Dalam Indeks LQ45"*. The aim of this research is to find out what is the effect of NPM, ROA, and ROE to the stock's price of the companies in LQ45 index. The research object is the companies that listed in LQ45 index. In this research, they are using double regression linear method. The result of this research are :

- The NPM, ROA, and ROE is assembly significantly influence to the stock's price.
- In partially, the ROA is significantly influence to the stock's price.

9. Kuswanto (2011), *"Pengaruh Rasio Likuiditas, Leverage, dan Profitabilitas Terhadap Harga Saham (Studi Pada Perusahaan LQ45 yang Terdaftar di Bursa Efek Indonesia).* The aim of this research is to find out the influence from current ratio (CR), debt to equity ratio (DER), return on assets (ROA), return on equity (ROE), and net profit margin (NPM) to the stock price of the company that listed on the LQ45 board. The object of the research is the company that listed on LQ45 board in IDX. The analysis technique of this research is using the double linear regretion method. The result of this research are :

– The CR, DER, ROE, and NPM is having influence to the stock's price simultaneously.
– In partial, only CR and DER that influence the stock's price. While the ROE and NPM is not having any influence to the stock's price.

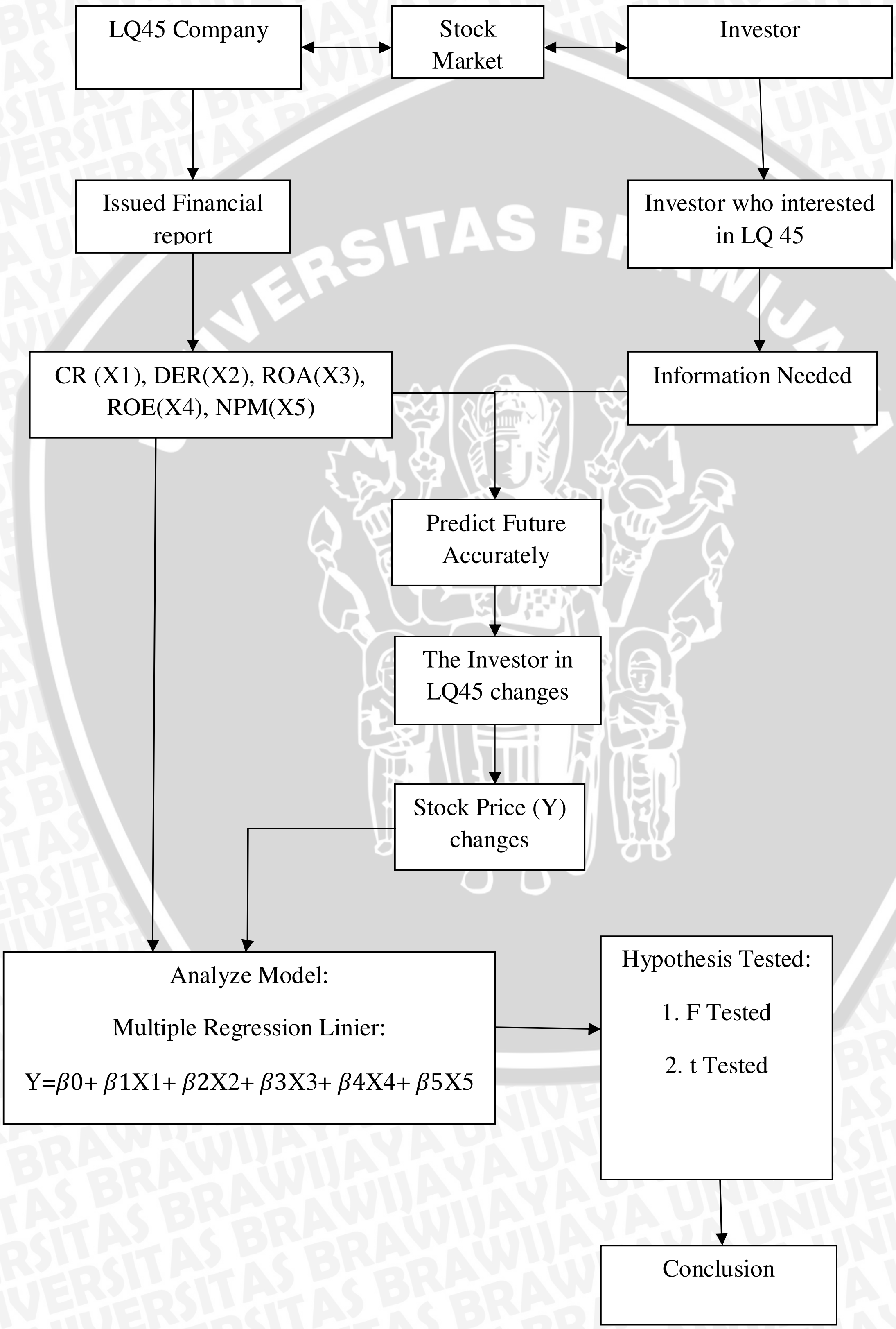
10. Mahardika (2011), *"Pengaruh Return on Asset, Debt to Equity Ratio, Total Asset Turnover, Current Ratio, Book Value Per Shares Terhadap Harga Saham (Studi pada Perusahaan Pertambangan yang Terdaftar di Bursa Efek Indonesia, Periode Penelitian Tahun 2005 – 2009)"*. The aim of this research is to find out the influences of ROA, DER, TATO, CR, and BVS to the stock's price of the mining company. The object of this research is the mining company that listing on IDX. The analysis technique of this research is using the double linear regretion method. The result from this research are :

- ROA, DER, TATO, CR, and BVS is significantly influences the stocks price.
- In partially, there are ROA, DER, and BVS that significant influence to the stock's price.
- TATO and CR is not significant influence to the stock's price.
- ROA is the dominant variable in stock's price.

11. Lindayati (2011), *"Pengaruh Rasio Keuangan Terhadap Harga Saham (Studi Empiris pada Perusahaan yang Terdaftar di Bursa Efek Indonesia)"*. The aim of this research is to find out whether the Total Debt to Equity Ratio, Total Debt to Asset Ratio, Total Asset Turnover, Operating Profit Margin, Net Profit Margin, Return on Investment, Return on Equity is having influence to the stock's price. The object of this research is the company that listing in IDX. The analysis technique of this research is using the multiple linear regression method. The result from this research are :

- The Total Debt to Equity Ratio, Total Debt to Asset Ratio, Total Asset Turnover, Operating Profit Margin, Net Profit Margin, Return on Investment, Return on Equity is significantly influence to the stock's price.
- Partially, there are only NPM, ROI, and ROE that significant influence to the stock's price
- ROI is the dominant variable in stock's price.

2.6. Research Systematic



2.7. Hypothesis development

Hypothesis is the temporary idea from research that has to be tested to get the fact. From explanation above and from previous research, hypothesis from the research are:

a. H1: the Current Ratio, Debt to Equity Ratio, Return on Assets, Return on Equity, and Net Profit Margin influence assembly towrds stock price.
b. H2: the Current Ratio, Debt to Equity Ratio, Return on Assets, Return on Equity, and Net Profit Margin influence partialy towards stock price.