CHAPTER II

REVIEW OF RELATED LITERATURE

A. Working Capital

1. Definition of Working Capital

There are some opinions expressed by experts about the definition of working capital. According to Keown, Martin, Petty and Scott (2002:607) "Working capital is the firm's total investment in current assets or assets that it expects to be converted into cash within a year or less".

According to Brigham and Houston (2003:689) "Working Capital is a firm's investments in short – term assets – cash, marketable securities, inventory, and account receivable."

The other definition that expressed by Lee and Lee (2006:394) "Working capital is the dollar amount or the total of a firm's current assets. Current assets include cash, marketable securities, investments, account receivable, and inventories."

Therefore, regarding some definition above, it can be concluded that working capital is cash or bank, securities are easily cashed (e.g., demand deposits, checks, deposits), accounts receivable and inventory turnover rate not exceeding 1 year or a period of normal operation of the company.

2. Types of Working Capital

According to Brigham and Houston (2003:689) explains that working capital consists of two concepts which is net working capital and gross working capital as follows :

a. Net working capital is current assets minus current liabilities.

b. Working capital sometimes called gross working capital refers to current assets used in company. It is a firm's investment in short-term assets-cash, marketable securities, inventory, and accounts receivable.

The other explanation by Lee and Lee (2006:394) stated that the types of working capital are as follows:

a. Permanent working capital is the dollar amount of working capital that remains fairly constant over time, regardless of fluctuations in sales.
b. Temporary working capital is the additional assets required to meet seasonal or cyclical variations in sales above the permanent level.

3. The Component of Working Capital

Basically, working capital has several components. According to Brigham and Houston (2003:696-710), working capital consist of four main components as follows

a. Cash. Cash is often called a "nonearning asset". It is needed to pay for labor and raw materials, to buy fixed assets, to pay taxes, to service debt, to pay dividends, and so on.
b. Marketable Securities. A marketable security is securities that can be sold on short notice. Marketable securities typically provide much lower yields than operating assets. In such situations, the marketable securities could be used as a substitute for transactions balances, for precautionary balances, for speculative balances, or for all three. There are some benefits and costs associated with holding cash and marketable securities. The benefits are as follows:
   1) The firm reduces transaction costs because it won't have to issue securities or borrow as frequently to raise cash.
   2) It will have ready cash to take advantage of bargain purchases or growth opportunities.

   The primary disadvantage of holding marketable securities is that the after-tax return on cash and short-term securities is very low. Thus, firms face a trade-off between benefits and costs.
c. Inventory. Inventory is current assets, composed of raw materials to be used in production, work in process, and finished goods.
d. Account Receivable. Account receivable is created when a firm sells goods to customer on credit. Account receivable also explained as

money owed to the firm by customers; the amounts not yet collected from customer for goods or services sold to them (after adjustment for potential bad debts).

The other description about components of working capital according to Lee and Lee (2006:396) "Cash is used to buy the necessary raw material that will be used in the production of goods and services. These goods are sold to customers. This increase account receivable. As customers pay their bills, account receivables are once again turned into cash. If there is a temporary surplus of cash, it may be used to purchase marketable securities. Marketable securities. By holding marketable securities, a firm can earn interest on surplus funds, but can quickly covert these funds back into cash when needed."

4. The Needs for Working Capital

In company, working capital can be used for several things. Companies usually need working capital to carry out their routine operations, but the level of their need varies directly with the level of service they provide and the amount of resources committed to providing them. According to Frank (2006:344) "Obviously, the more service provides, the more resources are committed, the more working capital it will need".

According to Frank (2006:344), "Regardless of the service levels or resource commitments, the working capital needs depend on two basis factors: permanent need and seasonal or temporary needs. The permanent need, which consist of fixed assets plus the permanent portion of current assets (usually the receivables), is more less stable, meaning that it does not change much throughout the year. The seasonal need, which consists of the temporary portions of current assets, on the other hand, varies during the year. In order to a large measure, these variations determine the working capital policy of a company, where the company must decide how much net working capital it will have to maintain relative to its seasonal and permanent needs for the purposes of carrying out its routine operations". The relationship between current and fixed assets, as well as between permanent and seasonal fund requirements can be seen in figure 1.

Furthermore, relationship between current and fixed assets, as well as between permanent and seasonal fund requirements according to Frank (2006:344) can be describe in Figure 2 as follows

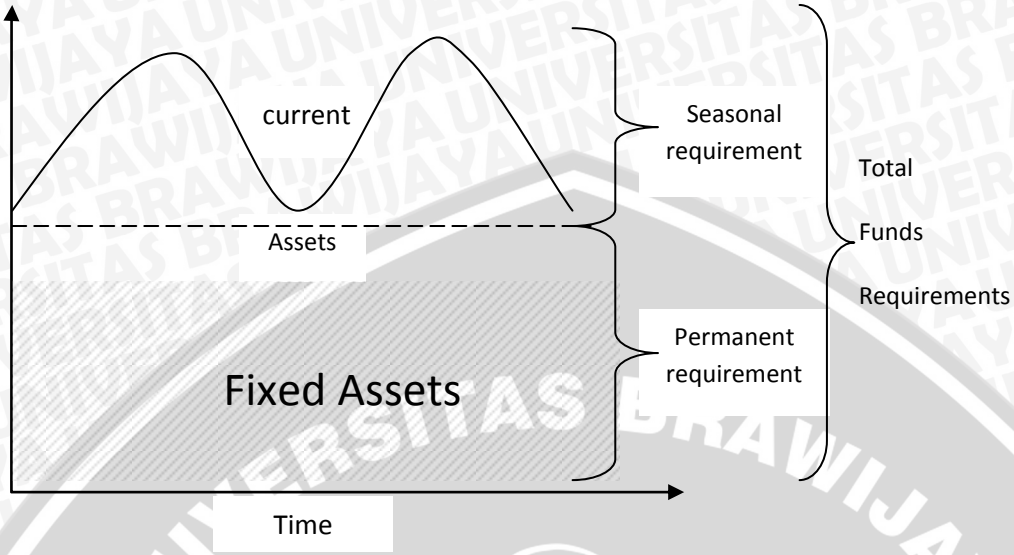

Figure 1: Relationship between current and fixed assets, as well as between permanent and seasonal fund requirements

The other opinion that describe by Atrill and Mc Laney (2006:368), "The size and composition of working capital can vary between industries. For some types of business, the investment in working capital can be substantial. Working capital represents a net investment in short-term assets. These assets are continually flowing into and out of the business, are essential for day to day operations".

5. Working Capital policy

Working capital policy related to the amount of targeted current assets and the way of financing (Weston and Brigham, 2009:417). Working capital financing also has relationship with the alternative policy that should be taken by a company.

There are working capital policy refers to the firm's policies regarding as follows:

a. Target levels for each category of current assets, and

b. How current assets will be financed (Brigham and Houston, 2003:690).

According to Weston and Brigham (2009:417) there are several alternatives of investment policy in current assets related with working capital.

a. Relaxed working capital asset policy. It require the company has the availability of cash, marketable security, and inventory in a big amount and has an effort to increase the selling by relaxed credit sales policy, so it can caused the increasing of account receivable.
b. Restricted working capital asset policy. It is the policy that has effort to minimize the amount of marketable securities, inventories, and account receivable of the company.

There are four basic measure or policy choices available to determine an appropriate mix of short-term and long-term financing. Understanding this policy is crucial, since they serve as the foundation of working capital management. According to Frank (2006:346-350) the policies are as follows:

a. Matching policy. It is one of the oldest policies. According to the principle, an organization must finance its short-term needs with short-term sources (such as short-term borrowing) and long term needs with long-term sources (such as long-term debts). It is called as "matching principle" because the objective is to "match" the maturity of the sources of funds to the length of time the funds are needed. The matching principle produces lower risk and lower financing cost for organization in the long run.
b. Aggressive policy. Under an aggressive policy, an organization will finance its seasonal needs as well as some of its permanent needs with short-term funds. The aggressive policy operates with minimum net working capital, since only the permanent portion of the current assets is financed with long term funds. Using short-term funds to finance short-term needs as well as some of its permanent needs is relatively inexpensive, but it is also risky.
c. Conservative policy. A conservative policy is the exact opposite of an aggressive policy. Under the conservative policy, a company uses long-term funds to finance its permanent needs, as well as a portion of its seasonal needs. Short-term funds support only the very tip of the seasonal working capital. When long-term funds are used to finance permanent, as well as some seasonal needs, it produces excess funds for company that can be invested in short-term securities. This ensures that funds are available at all times to meet the working capital needs of a company. Since there is very little possibility of running out of funds, it will produce very little risk for the company; hence the term "conservative" policy. The conservative policy is safe but costly.

d. Balanced policy. Under the balanced policy, a company is expected to maintain sufficient net working capital and long-term funds to meet permanent as well as seasonal needs. The advantage of this policy is that it provides a safety factor to cover unexpected seasonal needs using short-term funds that have not been planned.

B. Working Capital Management

1. Definition of Working Capital Management

There are some opinions expressed by experts about the definition of working capital management. According to Lee and Lee (2006:394) "Working capital management is a much broader concept than working capital because it involves the management of current assets, current liabilities, and the interrelationship between them."

The other explanation according to Horne and Wachowicz (2005:214-217), definition of working capital management including administration and fund its current assets needed to support current assets. Working Capital Management Company underlies two important decisions. Working capital management is a determinant of:

a. Optimal level of investment in current assets
b. An appropriate mix between short-term financing and long term that is used to support investment in current assets.

According to Brigham and Houston (2003:690) "Working capital management involves both setting working capital policy and carrying out that policy in day-to-day operations".

2. The importance of working capital management

Working capital is very important to a company. Without working capital, a company cannot continue to trade (Pike, 2003:396). For most firms, it constitutes a sizeable proportion of total assets employed. Working capital should be sufficient in number in the sense should be able to finance expenditures or operating a company day-to-day, because with sufficient working capital will be profitable for the company.

The other explanation according to Weston and Brigham (2009:412) there are several reasons that caused working capital management has important role as follows:

a. Working capital is used to fulfill the internal operations in company
b. Current asset management is dynamic process and requires the company notice the selling accurately, so that company can make sure the assets is adequate to fulfill the selling target and production.
c. Working capital management is important for small company. Although small company can limit the investment in current assets by leasing the building and equipment, but they cannot avoid the investment in form of cash, receivable, and inventory. Moreover, because small company is difficult to join with long term market share, therefore they will dependent to account payable and long term credit which influence working capital by increase the current liabilities.
d. The growth of selling has close and direct relationship with investment in form of current assets. The increasing of selling, the company should increase the receivable, inventory, and cash. The company has to finance all the need. Therefore, financial manager should notice the trend of selling and it influence through the need of working capital.

2. Definition of Efficient and Effective

In order to measure effective and efficient working capital, we need to understand the definition of efficiency first. According to Bull (2008:112),

> "Efficiency is most relevant to the way an enterprise manages its asset and generates value from them. The asset turnover ratio and to a lesser extent

> the profit margin are therefore the best indicators of efficiency and these combine together in the return on assets ratio. We have seen that the return on equity and the dividend yield can be helpful shorthand ratios for shareholders to use in assessing the effectiveness with which a company uses their investment." Measure efficiency takes the inputs to a process and assesses how economically they are used to produce a given output."

The other description of efficiency that describe by Lee and Lee (2006:543), "Efficiency assumes the optimal allocation of resources. Efficiency is a contract, routine, process, organization, or system is efficient in this sense if there is no alternative that consistently yields unanimously preferred results".

The other term that needed to understand is effectiveness. Effectiveness assesses the value of output produced from a given set of resources. This subtly shifts our focus from measures it represents a shift from measuring cost to measuring value (Bull, 2008:112).

3. Effective and Efficient Working Capital Management

In assessing the effective working capital, it closely related with managing the element of working capital. It is necessary for management to decide how much of each element should be held.

The working capital cycle according to Atrill and McLaney (2006:369)

> "Cash is used to pay trade payables for raw materials, or raw materials are bought for immediate cash settlement; cash is spent on labor and other aspects that turn raw materials into work in progress and, finally, into finished goods. The finished goods are sold to customers either for cash or on credit. In the case of credit customers, there will be a delay before the cash is received from the sales. Receipt of cash completes cycle".

Therefore, working capital cycle according to Atrill and McLaney (2006:369) can be describe on figure 2 as follows :

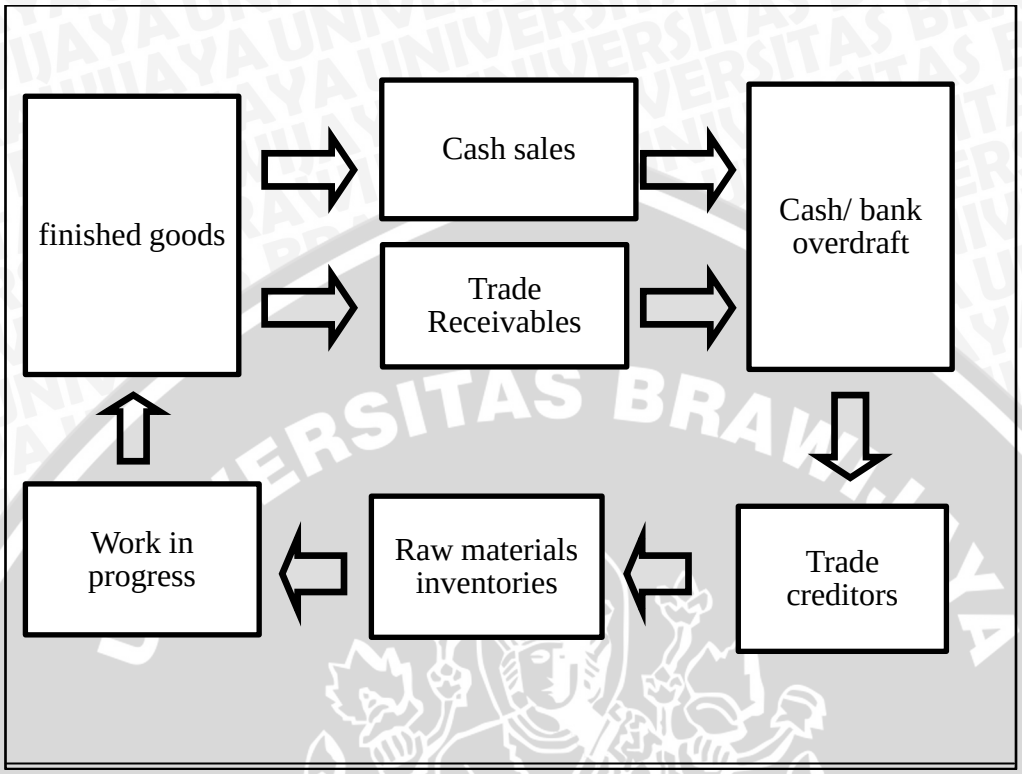

Figure 2 The Working Capital Cycle

The other description of working capital management according to Brigham and Houston (2003:690) "Firms typically follow a cycle in which they purchase inventory, sell goods on credit, and then collect account receivable. This cycle is referred to as the cash conversion cycle, and it is discussed in detail in the next section. Sound working capital policy is designed to minimize the time between cash expenditures on materials and the collection of cash on sales".

Therefore, in order to achieve effective and efficient working capital, managing the element of working capital is needed.

1. Managing Cash

   Cash is the money on hand, as well as cash balances in bank accounts. Company usually keeps cash balances in bank accounts to pay bills as

they become due and as a precaution against unforeseen situations (Frank, 2006:339).

According to Brigham and Houston (2003: 698), firms hold cash for several reasons:

1) Transactions balance. A cash balance associated with payments and collections; the balance necessary for day-to-day operations.
2) Compensating balances. A bank balance that a firm must maintain to compensate the bank for services rendered or for granting a loan.
3) Precautionary balance. A cash balance held in reserve for random, unforeseen fluctuations in cash inflows and outflows.
4) Speculative balance. A cash balance that is held to enable the firm to take advantage of any bargain purchases that might arise.

According to Brigham and Houston (2003:699), working capital management requires that an ample supply of cash and near-cash assets be maintained for several specific reasons as follows

1) It is essential that the firm have sufficient cash and near-cash assets to take trade discounts. Trade discount is a price reduction that suppliers offer customers for early payment of bills.
2) Adequate holding of cash and near-cash assets can help the firm maintain its credit rating by keeping its current and acid test ratios in line with those of other firms in its industry. A strong credit rating enables the firm both to purchase goods from suppliers on favorable terms and to maintain an ample line of low-cost credit with its bank.
3) Cash and near-cash assets are useful for taking advantage of favorable business opportunities, such as special offers from suppliers or the chance to acquire another firm.
4) The firm should have sufficient cash and near-cash assets to meet such emergencies as strikes, fires, or competitors' marketing campaign, and to weather seasonal and cyclical downturns.

According to Brigham and Houston (2003:692), cash conversion cycle, which nets out the three periods just defined and which therefore equals the length of time between the firms' actual cash expenditures to pay for production resources (materials and labor) and its own cash receipts from the sale of products (that is, the length of time between paying for labor and materials and collecting on receivable). The cash conversion

cycle thus equals the average length of time a dollar is tied up in current assets.

(1)		(2)		(3)		(4)
Inventory Conversion Period	+	Receivables Collection Period	–	Payables Deferral Period	=	Cash Conversion Period

The amount of cash balance in a company as well as not over and not lack because it will has impact to loss of company. One of the ways that can be used to determine the amount of cash balance is Baumol Model. According to Lee and Lee (2006:31), "The Baumol's model strives to equate the two opposing marginal costs associated with ordering and holding inventory to minimize total costs". Minimum cash of the company can be calculated as follows:

$$C = \sqrt{\frac{2\,(F)(T)}{k}}$$

Which C = optimum cash amount

F = fix cost to obtain loan or selling securities

T = cash amount to transaction during certain period

k = opportunity cost from cash owned

2. Managing Marketable Securities

The description about marketable securities according to Frank (2006:339) "During the normal course of operation, company accumulate cash surplus, resulting from the differences in cash receipts and cash disbursements, which, rather than holding in currency, or in time deposits, they can invest in marketable securities to generate non-tax revenue. Marketable securities are short-term investments with a life span of less than a year that pay a modest return and are relatively secure. It called as marketable securities because these issues can be sold quickly to generate instant cash".

According to Brigham and Houston (2003:706), there are both benefits and costs associated with holding cash and marketable securities. The benefits are as follows:

1) The firm reduces transactions costs because it won't have to issue securities or borrow as frequently to raise cash
2) It will have ready cash to take advantage of bargain purchases or growth opportunities.

The other explanation the disadvantage of holding cash and marketable securities is that the after-tax return on cash and short-term securities is very low.

3. Managing Account Receivable

Account receivable represent income or revenue from user fees, charges, fines, forfeitures, as well as from other agencies and company that a company has not yet received, but expects to receive within a prescribed time during an accounting period (Frank, 2006:339-340).

According to Brigham and Houston (2003:690-691), "Receivables collection period, which is the average length of time required to convert the firm's receivables into cash, that is, to collect cash following a sale. The receivables collection period is also called the days sales outstanding (DSO), and is calculated by dividing accounts receivables by the average credit sales per day".

$$\text{Receivable Collection Period} = \text{DSO} = \frac{\text{Receivables}}{\text{sales}/365}$$

4. Managing Inventory

According to Frank (2006:340) "Company need to maintain inventories (unused goods, materials, and supplies) to ensure that they are available when needed. Not having enough inventories when needed for a job creates a cost burden for a company from work delay. On the other

hand, having too much inventory can also add to the cost of operation due to obsolescence, breakage, theft, and the use up of storage space. The objective is to maintain an inventory level at which these costs will be minimum, while making sure that the level is sufficient to meet the needs as they arise".

According to Brigham and Houston (2003: 707), inventories which may be classified as follows:

1. Supplies
2. Raw materials
3. Work-in-process
4. Finished goods

Basically, according to Brigham and Houston (2003:707) inventory management also has goals which is

1) To ensure that the inventories needed to sustain operations are available, but
2) To hold the costs of ordering and carrying inventories to the lowest possible level.

Inventory costs can be divided into three types: carrying costs, ordering costs, and stock-out costs. In general, carrying costs increase as the level of inventory rises, but ordering costs and stock-out costs decline with larger inventory holdings.

According to Brigham and Houston (2003:690), inventory conversion period, which is the average time required convert materials into finished goods and then to sell those goods.

$$\text{Inventory Conversion period} = \frac{\text{Inventory}}{\text{Sales per day}}$$

5. Managing Account Payable

Payables generally occur when a buyer buys from a supplier on credit. When a credit sale is made, the supplier records a receivable and the purchaser records a payable (Frank, 2006:340).

According to Brigham and Houston (2003:690), "Payable deferral period, which is the average length of time between the purchase of materials and labor and the payment of cash for them".

$$\text{Payables deferral period} = \frac{\text{Payable}}{\text{Purchases per day}}$$

$$= \frac{\text{Payable}}{\text{Cost of goods sold}/365}$$

C. Financial Ratio Analysis

In order to assess the effective management of working capital and can efficiently be done by using ratio analysis. According Atrill and Mclaney (2006: 168), "Financial ratios provide a quick and relatively simple means of assessing the financial health of business".

According to Lee and Lee (2006:226), "Ratio analysis is another means by which to gain insight regarding a firm's strength and weaknesses. Ratios are constructed by dividing various financial statement numbers into one another. The ratios then can be examined to determine trends and reasons for changes in financial statement quantities. Ratios are valuable tools, as they standardize balance sheet and income statement numbers".

Regarding the explanation above, it can be concluded that financial ratio is a tool that can describe a particular relationship between single factors with another factor of a financial report. The purpose of ratio analysis is to assist financial management understand what needs to be done by the company based on the available information is limited nature of the financial statements.

Therefore, there are three basic categories of financial ratio analysis typically are used as follows:

1. Time series analysis. Financial ratios can be used in time series analysis to evaluate firm performance over time. The best information source for time series analysis of firm financial ratios is the firm's financial statements and their footnotes.
2. Cross-sectional analysis. Financial ratios can be used in cross-sectional analysis, in which different firms are compared at the same point in time. The best information source for cross-sectional analysis of firm financial ratios is the firm's financial statements and their footnotes.
3. Benchmark analysis. Financial ratios can be used in benchmark analysis, in which the ratios of a specific firm can be compared to benchmark, such as the industry average or an ideal target or goal determined by management (Lee and Lee, 2006:32, p. 77, and p. 273).

According Bertoneche (2001:74), financial ratios consist of:

1. The liquidity ratio

   Liquidity ratio measure a borrower's ability to meet its obligation in near term (Marks, Robbins, Fernandez and Funkhouser, 2005:187).

   According to Atrill and McLaney (2006:169), "Liquidity is vital to the survival of business for there to be sufficient liquid resources available to meet maturing obligations (that is, debts that must be paid in the relatively near future). Some liquidity ratios examine the relationship between liquid resources held and payables (creditors) due for payment in the near future".

   According to Bertoneche (2001:86), liquidity can be divided into several calculations, as follows:

   a) Net Working Capital

      According to Lee and Lee (2006:189-190), "Net working capital, the difference between current assets and current liabilities, is a financial indicator that can be used in conjunction with ratio analysis to gauge a firm's liquidity. An increase in net working capital is a net investment in the firm's current assets; and an increase in an asset is considered a use of cash. A decrease in net working capital is a divestment of assets, that is, a source of cash. In general, an abundance of net working capital

suggests that the firm has ample liquidity to meet its short-term obligations".

Net working capital can be measure as follows

Net working capital = current assets – current liabilities

b) Current Ratio

Current ratio compares the 'liquid' assets (that is, assets held cash and those that Will soon be turned into cash) of the business with the current liabilities (Atrill and McLaney, 2006: 187).

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

c) Cash Ratio

The cash ratio relates cash, cash equivalents, and marketable securities to current liabilities. The ratio indicates the extent of assets available to pay off current liabilities. A higher ratio indicates a better level of cash solvency (Wang, 2006:151).

$$\text{cash ratio} = \frac{\text{Cash and Cash Equivalents} + \text{Marketable Securities}}{\text{Current Liabilities}}$$

d) Quick ratio

Quick ratio removes the non-liquid inventories number from the current ratio. This ratio measures if the firm would be able to repay its short-term liability assuming inventory is not sold (Bertoneche, 2001: 43).

$$\text{Quick Ratio} = \frac{\text{Current assets} - \text{inventory}}{\text{Current Liabilities}}$$

2. The activity ratio

The activity ratios are measures which attempt to evaluate how effectively capital is employed within the firm. The emphasis is on the scale of business generated off the capital base rather than on profitability directly (Bertoneche, 2001:80). This ratio may be used to measure the efficiency with which particular resources have been used within the business (Atrill and McLaney 2006:190). Activity ratio can be divided into several calculations, as follows:

a) Asset Turnover

The asset turnover measures the turnover of all the firm's assets (Brigham and Ehrhardt, 2004: 128).

$$\text{Asset turnover ratio} = \frac{\text{Sales}}{\text{Total assets}}$$

b) Inventory Turnover

One measure that managers commonly use to evaluate inventory levels is inventory turnover, which is the average number of times a company sells its inventory during an accounting period (Brigham and Ehrhardt, 2004: 126).

$$\text{Inventory turnover} = \frac{\text{cost of good sold}}{\text{inventories}}$$

c) Average Day Inventory

Average day inventory help the manager to quantify the operating cycle. It is also used to calculate the average period inventory that exist in company (Lee and Lee, 2006 :21).

$$\text{Average Day Inventory} = \frac{\text{inventories x 360}}{\text{cost of good sold}}$$

d) Account Receivable Turnover

This ratio compares receivables to sales so as to estimate how efficiently payments are received from customers. In general, a higher accounts receivable turnover ratio suggest more frequent payment of receivables by customers. (Lee and Lee, 2006 :20).

$$\text{Account Receivable Turnover} = \frac{\text{Sales}}{\text{Average Account Receivable}}$$

e) Average Collection Period

Comparing the average collection period to the firm's credit terms indicates whether customers are generally paying their accounts on time (Lee and Lee, 2006 :20). .

$$\text{Average collection period} = \frac{\text{Average Account receivables x 360}}{\text{Sales}}$$

f) Working Capital Turnover

Working capital turnover are used to measure the ability of working capital (netto) that has cash cycle in company (Lee and Lee, 2006 :21)

$$\text{Working capital turnover} = \frac{\text{Sales}}{\text{current asset} - \text{current liabilities}}$$

3. Profitability Ratio

Profitability ratio shows the ability of a firm to use its sales, assets, and equity to generate returns (Lee and Lee, 2006:217). Profitability is also to consider the company as to be able to hold his life, so the management company will try to increase corporate profits. Profitability [ratios measurements consist of several types, namely:

a) Gross Profit Margin

A usual place to start is gross margin, this reflects the firm's pricing policy and shows the profit margin on sales over and above the direct cost of sales (Bertoneche, 2001:77).

$$\text{Gross Margin} = \frac{\text{Gross Margin}}{\text{Revenues}}$$

b) Net Profit Margin

The profit margin measures how profitable the firm has been with respect to sales. Net profit margin is percentage of each sales dollar that contributes to net income (Needles and Powers, 2007:852).

$$\text{Net Profit Margin} = \frac{\text{net income}}{\text{net sales}}$$

c) Return on Investment (ROI)

The basis of evaluation is usually the return on investment (ROI), as this allows comparison of the performance of units of varying sizes. This is calculated as the return from a project as a percentage of the amount invested (Gazely and Lambert, 2006:68).

$$\text{ROI} = \frac{\text{Net income}}{\text{Total assets}}$$

d) Return on Assets (ROA)

The return on assets ratio measures how efficiently the firm uses its total assets to generate income (Bertoneche, 2001:78).

$$\text{ROA} = \frac{\text{Earning Before Interest and Tax (EBIT)}}{\text{Total assets}}$$

e) Return on Equity (ROE)

This is the most used commonly measure profitability and is calculated by taking the net income as a percentage of equity. It also shows how funds are working hard stakeholders (Bertoneche, 2001:79).

$$\text{ROE} = \frac{\text{Net income}}{\text{Stockholder's equity}}$$

4. The financial (leverage) ratio

The last dimension of financial health is the financial structure of the business. According to Chorafas (2002:130) "The leverage ratio measure the contributions of owners as compared to financing provided by creditors".

a) Debt ratio

This simply indicates the percentage of assets financed by debt (Bertoneche, 2001:84).

$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

D. Profitability

1. Understanding Profitability

In order to assess working capital, it needed understanding about profitability because it is one of important component in company. According to Kaliski (2001:386), "Profitability ratios are gauges of the company's operating success for a given period of time".

According to Atrill and McLaney (2006:169) "Profitability ratios provide an insight to the degree of success in achieving this purpose. They express the profits made (or figures bearing on profit, Such as overheads) in relation to other key figures in the financial statements or to some business resource".

The other definition of profitability according to Brigham and Houston (2003:99), "Profitability is the net result of a number of policies and decisions. The ratios examined thus far provide useful clues as to the effectiveness of a firm's operations, but the profitability ratios show the combined effects of liquidity, asset management, and debt on operating results."

Regarding the definition above, it can be concluded that profitability ratios is used to show the ability of a firm to use its sales, assets, and equity to generate returns.

2. The Importance of Profitability Ratios

Benefits of profitability ratios is not limited to business owners or management, but also for parties outside the company, especially parties - parties that have any connection or interest with the company.

According to Bertoneche (2001:80), explains that the key purposes of using the profitability ratio are as follows:

a. Indicate the firm's ability to generate revenues in excess of expenses
b. Measure the firms' ability to create value and show how: competitive position is translated to profit margins; efficiency produces cost advantages, profit exceeds capital charges
c. Signal the firm's ability to compensate shareholder for risk

E. Projected Financial Statements

Financial statements show how the managers and investors analyze them to evaluate a firm's past performance. While this is clearly important, it is even more important to look ahead and to anticipate what is likely to happen in the future.

Therefore, both managers and investors need to understand how to forecast future results.

According to Brigham and Houston (2003:134), "Projected financial statements is financial statements that forecast the company's financial position and performance over a period of years".

Projected financial statements can be used in four ways as follows:

1. By looking at projected statements, managers can assess whether the firms' anticipated performance is in line with the firm's own general targets and with investors' expectations.
2. Projected financial statements can be used to estimate the effect of proposed operating changes.
3. Managers use projected financial statements to anticipate the firm's future financing needs.
4. Projected financial statements are used to estimate future free cash flows, which determine the company's overall value. Thus, managers forecast free cash flows under different operating plans, forecast their capital requirements, and then choose the plan that maximize shareholder value (Brigham and Houston, 2003:134).

Regarding the explanation above, it can be concluded that projected financial statements of the company are a projection or estimate of the financial condition and results of operations for the next year. Projected financial statements related to projected income statement and balance sheet projections.