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CHAPTER II

REVIEW OF RELATED LITERATURE

A. Company Objectives

Every activity held by company is to achieve a particular goal, for the smoothness operation of the company, so the company's goals need to be understood by all parties that exist within the company.

Based on existing economic theory, the company has a main goal is to maximize profit is obtained, like what is stated by Nicholson and Synder (2012:372) “profit maximization most models of supply assume that the firm and is manager pursue the goal of achieving the largest economic profit possible”. Moreover the following definition embodies this assumption and also reminds the reader of definition of economic profit. This is reinforced the statement by Benerjee (2008:568) the objective of corporation are to:

1. Ascertain quality and effectiveness of compliance or corporate governance.
2. Improve overall legal framework to make it internationally compatible.
3. Create an environment of competitiveness in showing best corporate practice and advice companies’ excellence forward.

Benerjee (2008:8) stated that “the financial management process and consequently, the finance manager have to operate in tandem with the general management function in achieving the goals or objectives of the company”. Thus profit maximization has the objective to maximize profits is a rational purpose in the business world and focus the company to earn income. Shim

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and Siegel stated that (2008:2) “profit maximization is basically a single period or at most, a short-term goal, to be achieved within one year it is usually interpreted to mean the maximization of profits within a given period of time. Corporations maximize its short-term profits at the expense of its long term profitability. In contrast stockholder wealth maximization is a long term goal, since stockholders are interested in future all well as present profits”. Moreover, it can be taken a firm understanding that the real purpose of wealth maximization can be achieved if profit maximization is reached first, which means that short-term goals cannot be ignored.

B. Analysis of Financial Statements

Companies in order to see whether it has achieved its purpose or not, it can be done by assessing the performance of the company. One way that can be done to assess the performance of the company is to analyze the company's financial statements. According to Rao (2011:45) “there are three steps involved in the analysis of financial statements. They are selection, classification and interpretation. Selection of data related, to the purpose of analysis financial statement. Classification is the methodical segregation and arrangement of the data. Interpretation is the drawing of inferences and conclusions”.

According to Needles and Powers (2007:48) “financial statement analysis is a powerful mechanism to determine strength and weaknesses of an enterprise which depends on the data of financial statements”. According to Rao stated that (2011:44) “financial statement analysis is a process of

evaluating the relationship between component parts of financial statement to obtain a better understanding of a firm position and performance". Moreover according to Gapenski (2007:491) "financial statement analysis involves a number of techniques that extract information contained in a business financial statements a combine it in a form that facilitates making judgment about the firm's financial condition".

Based on the above three theories, it can be concluded that analysis of financial statements is a deliberative process in order to help evaluate the financial position and company's operating results in the present and past, with the primary objective to determine the estimation and prediction of the condition and performance of companies in the future.

1. Financial Statements

For an analyst of financial statements, one of the most important tools in performing and implement its function as an analysis is a financial statement. The financial statements have several definitions.

According to Myers in Rao (2011:44) "financial statements is largely a study of the relationship among the various financial factors in a business by a single set of statements and study of the trend of these factors as shown in series of statements". Another statement by Ogilve (2005:254) "the financial statement provide of the accounts of a business enterprise, the balance sheet reflecting the assets, liabilities and capital as on certain date and the income statement showing the result of operation during a certain period". Other theory from Kramer and Johnson (2009:3)

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"financial statements are the output of the accounting process, a formal way of communicating financial information that can be used by a variety of parties in making decision about business". Bose (2010:254) stated that "a financial statement is a collection of data organized in according with logical and consistent accounting procedure. In other words, it is the outcome of summarizing process of accounting". Other definition by Needles, Powers and Crosson (2011:19) "financial statement is the primary means of communicating important accounting information about a business to those who have an interest in the business. These statements are models of the business enterprise in that they show the business in financial terms".

Rao (2011:22) explain that, "a financial statement is a collection of facts and figures organized according to systematic accounting procedures. Financial statements are known as financial report in the sense that it is prepared to communicate to different users, presented in the form of annual report, and representing a consolidated position at the end of the accounting". Based on some of above understanding, it can be concluded that financial statements are an accountability report manager or head of company which contains a summary of transactions made by company in a given period which can describe company's assets.

Financial statement consists of several types. There are four types financial statement according to Kramer and Johnson (2009:8):

a. The balance sheet
   The balance sheet presents the assets, liabilities, and residual equity of the owner or owners of a business.
b. The income statement
   Basic financial statements we are introducing you to the income statements present the revenues and expenses of the business over a period time
c. The statement of owners equity
   Financial statements we will introduce you to be called the statement of owner's equity. Since stockholders are the owners of a corporation,

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it stands to reason that this statement is referred to as the statement of stockholders equity for corporations.

d. The statement of cash flows
Financial statement that we are going to introduce you is the statement cash flows.

According to Bose (2010:254) set of financial statements consist of:

a. Income statement
Income statement is a statement of revenues earned and the expenses incurred for earning that revenue. Revenue and income is the golden egg the center of attraction of all those interested in the concern.
b. Balance sheet
The balance sheet is one of the important statements depicting the financial position of the concern.
c. Retained earnings
The statement of retained earnings or profit a loss appropriation accounts explain the utilization of profit a concern and states the extent of unutilized amount of profits retained as such.
d. Statement of changes in financial position
The statement of changes in financial position shows the changes in assets and liabilities from the end of one period to the end of another point of time. The statement explains the movement of funds (working capital or cash) during a particular period).

According to Brigham and Houston (2003:88) the four basic statements contained in the annual report are:

a. The balance sheet
Show assets, on the right-hand side and liabilities and equity, or claims against assets, on the right-hand side. The balance sheet may be thought of as a snapshot of firm's financial position at a particular point in time.
b. The income statement
Report the result of operations over a period of time, and it shows earnings per share as its "bottoms line".
c. The statement of retained earnings
Show the change in retained earnings between balance sheet dates, retained earnings represents a claim against assets, not assets per se.
d. The statement of cash flows
Report the effect of operating, investing, and financing activities on cash flows over an accounting period.

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Based on the opinions above, it can be concluded that there are two main financial statements, that are balance sheet and income statement, but in actual practice there are additional reports to support the report, including the cash flow statement and statement of retained earnings.

Financial statements in order to produce a proper analysis, it must meet several criteria. Accounting Indonesia on Munawir (2007:28) mentions the criteria, including:

a. Fulfill for:
   1) Provide quantitative information on the financial statements of certain companies, to meet the needs of users in making economic decisions.
   2) Present reliable information concerning the financial position and changes in net assets of the company.
   3) Presenting financial information that can assist users in assessing the ability of the company profit.
   4) Presenting other required information on changes in assets and liabilities, and disclose other information in accordance with the needs of users.
b. Achieve following quality:
   1) Relevant.
   2) Be clear and understandable.
   3) Verifiable.
   4) Reflect time to the company appropriate
   5) Can be compared.
   6) Complete and neutral.

2. Ratio Analysis

Ratio analysis is most popular technique of financial analysis. It is "the technique of analyzing and interpreting financial statements with the help of accounting ratios" Chandra (2008:278). A ratio is mathematical relationship between two items expressed in quantitative forms. It may be define as the indicated quotient of two mathematically expressions. However, a financial ratio the relationship between two accounting figures

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expressed mathematically. Another statement, according to Needles and Powers (2007:271), "ratio analysis is an evaluation technique that identifies key relationship between the components of the financial statements".

According to Rao (2011:60), "ratio analysis is a powerful tool of financial analysis used by financial analysis. It is process of establishing and interpreting different ratio showing quantitative relationships between figures and groups of figures. Ratio analysis is useful for assessment of business performance, evaluation of financial condition of an enterprise and making decisions in the business".

Actually there are several methods to analyze financial statements, but in this research used financial ratio analysis method, because analysis of this ratio has a forte among other methods, there are several ratios that can be used to analyze financial statements, according to Bose (2010:280) ratios are broadly classified into the following categories:

a. Profitability ratio
   Is an indicated of the efficiency with which the operations of concern are carried on if profit is what is left or a shareholder after all the changes have been paid profitability is ratio.
b. Liquidity ratio
   Liquidity means the ability of a concern to meet its current obligations as and when these became due. Thus the liquidity ratio indicated the ability of a concern to meet its short-term obligations.
c. Solvency ratios
   Measures the efficiency or effectiveness with which a concern manages its resources or assets. Activity ratios are also known as turnover ratios as they indicated the speed with which assets are converted or turned over into sales.

d. Solvency ratios
   The solvency or leverage ratios measure the financial position of a concern. Such ratio reflects the ability of the concern to assure the payment of long-term creditors in time.
e. Leverage or capital structure ratio
   Leverage ratios are found out mainly to test the long-term financial position of concern leverage.

According to Rao (2011:60) financial ratios divided into:

a. Liquidity ratio
   It measures the short-term solvency of a firm those are useful for understanding.
b. Leverage ratio
   It conveys an enterprise ability to meet interest costs and repayment of long-term debt.
c. Activity ratio
   It is calculated to measures the efficiency with which the resources have been employed. Some of the activity ratios are debtor's turnover ratio and creditor's turnover ratio.
d. Profitability ratio
   It measures the result of business activities, performance and effectiveness of the enter price. Profitability in relation to investment is individually prepared.

According to Shim and Siegel (2008:49) financial ratios can be grouped into the following types:

a. Liquidity ratio
   Is a company's ability to satisfy maturing short-term debt. It is crucial to carrying out the business, especially during periods of adversity.
b. Asset utilization ratios
   Ratio reflects the way in which a company uses its assets to obtain revenue and profit.
c. Leverage ratios
   Leverage is the company's ability to satisfy long-term debt as it becomes due.
d. Profitability ratios
   A company's ability to earn good profit and return on investment is an indicator of its financial well-being and the efficiency with which it is managed.

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Brigham and Houston (2003:156) financial ratio is designed to help evaluate financial statements:

a. Liquidity ratios show the relationship of a firm's current to its current liabilities, and thus its ability to meet maturing debt.
b. Asset management's ratios
   Measures how effectively a firm is managing its assets.
c. Debt management ratios
   Reveal (1). The extent to which firm is financed with debt, (2). It's like hood of defaulting on its debt obligations.
d. Profitability ratios
   Show the combined effects or liquidity, assets management and debt management policies on operating result.

C. Profitability

Profitability in terms of comes from the word "profit" and "ability" relates to company's ability to generate profits. According to Needles and Powers (2007:5) argued that the definition of profitability is "the ability to earn enough income to attract and hold investment capital". According to Brigham and Houston (2003:99) explain that: "Profitability ratio is a group of ratios that show the combined effects of liquidity, assets, management and debt operating result". Another statement according to Shim and Siegel (2008:49) explain that:, "profitability ratios, a company's ability to earn good profit and return on investment is an indicator of its financial well being and the efficiency with which it is managed". Moreover according to Lasher (2011:89), "profitability ratios is the most fundamental measure of a business success is profit without profit there are no dividends, and without dividends or the expectation of them, no one will invest in stock".

Based on what is disclosed in the above, it can be concluded that profitability is the ability of a company in their activities generate income through all the resources of the company, to increase the company must establish a greater investment in assets a profitable and actually provide results for the company. How to measure the profitability of the company there are many sizes, but usually each associated the company's with sales, assets, capital or stock value.

"Profit maximization is basically a single period or most a short-term goal, to be achieved within one year it is usually interpreted to mean the maximization of profit within a given period of time" (Shim and Siegel 2008:2). In accordance with the short-term goods of companies profit maximization, so it will be concerned on the profitability because to establish condition life a company must in of profitable or advantageous. Without the profit, it will be difficult for the company to attract capital from outside. It is like what was stated by Alice (2007:77) that, "person or institution that holds the debt issued by a firm or individual. Bond holder is the creditor; creditors do not usually have voting power. The device used by creditors to protect them is the loan contracts (that is the indenture)".

D. Factors That Affect The Company's Profitability

Actually there are many factors that could influence the company's ability to generate profits, it is related of how we measure the profitability. Profitability of company can be measured in two ways, but in this research the measurement is used through the ROA (Return On Asset).

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$$\text{Return on Asset (ROA)} = \frac{\text{Net Income}}{\text{Total Asset}}$$

The formula of ROA according Needles and Powers (2011:204):

To be able to maintain and improve ROA, companies need to know some factors that may affect it, including the Sales Growth (SG), Price Earnings Ratio (PER), and Debt Ratio (DR).

Further explanations of these factors are described as follows:

1. Sales Growth

The sale is the amount of revenue or income derived from the company's goods or services sold, either in cash or credit. At the company's sales industry is the only source of revenue. Amason (2011:139) argues that "sales growth is another common goal among many firms. Yet sales growth too is a reflection of other things, like the stage of environmental development, a superior resource position, or a temporary imbalance between demand and supply. Thus, sales growth is also the result of other more basic forces on which manager can and should focus". Moreover, according to Schwenker and Botzel (2007:12) "sales growth has traditionally been the yardstick of business success. Indeed, sales growth is the only lever that allows all of a company's performance indicators profit, cash flow, total shareholders return, etc to be atomized in parallel. It can give firms a clear indication of how they must respond to the market driven compulsion to grow". From here the company earned profit or profits, of course, after deducting the costs of company in producing the goods.

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Kaliski (2001:701) the basic formula for this objective is that profits equal revenue minus expenses

$$Profit = R - E$$

Revenue is determined by a product's selling price and the number of units sold. A company must be careful not to increase the price of the product too much, or the quantity sold will be declined and total profits may be lower than desired. Moreover, a company is always monitoring the price of its products in order to make sure it is competitive while at the same time providing for an acceptable profit margin.

Based on the above formula, one way to improve profits is to increase the company sales volume. Increase in sales led to an increase in earnings that much larger and otherwise decline in sales would lead to reduced amount of earnings disproportionate.

2. Price Earnings Ratio (PER)

Price Earnings Ratio (PER) is one of the ratios of market valuation which is often used to evaluate the financial performance of the external. There are several definitions of this ratio. PER according to Needles and Powers (2007:732) "PER is a measure of investor's confidence in a company and a means of comparing stock values; market price share: earnings per share". Brigham and Earnhardt argue that (2008:43) "PER shows how much investors are willing to pay per dollar of reported profits". According to Chandra (2008:79) "price earnings ratio perhaps the most popular financial statistic in stock market discussion". In addition,

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according to Atrill and Mc. Laney (2006:219) “The price earnings ratio relates the market value of a share to the earnings per share.” Price Earnings Ratios provide a useful guide to market confidence concerning the future and they can, helpful when comparing different businesses. However, differences in accounting policies between businesses can lead to different profit and earnings per share figures, and this can distort comparisons.

It can be concluded, that PER is the ratio of market valuation that shows the amount of money that investors invest for every dollar of profit from the company investment, or seen the opposite is what investors get from the amount of money they invest.

The formula Price Earnings Ratio (PER) according to the Atrill and Mc. Laney (2006:219):

$$\text{PER} = \frac{\text{Market value per share}}{\text{Earning per Share}}$$

While according to Chandra (2008:79):

$$\text{PER} = \frac{\text{Market price per share}}{\text{Earning per Share}}$$

High price earnings ratio of company show the highly growth of company, but applies opposites if the ratio PER owned a company is low, this shows rate the company's growth is also lower. Investors are more interested to companies has high price earnings ratio. Moreover according Investors Company that has higher PER value is one of assurance that

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their investment can be returned, of what they invest in these companies have the opportunity to increase profit of company.

3. Debt Ratio

Another factor that may affect the profitability of the company is debt ratio. The company's debt is usually used to increase the ability of companies to earn income through various activities, such as the following statement “If a lot of debt is used to finance increased operations (high debt to equity), the company could potentially generate more earnings than it would without this outside financing” (www.answer.com/debt-equity-ratio).

The use of debt in a company than to bring greater level of earnings, this is due to expense the form of interest related to debt. Higher use of debt will increase profitability; on the other hand, high debt will also increase the risk. If sales are high, then the company can get high profits, otherwise if the sale falls forced the company could suffer losses due to interest expense that must still be paid. Companies that have high levels of use of debt in financing operation the company is very risky, even so investors prefer companies, because investors have guidelines that the higher the risk, the higher return is obtained, but investors do not just release the funds held for the invested.

Investors need a guarantee that the investment can be returned, this can be seen from the ratio of debt. It is calculated:

$$DR = \frac{\text{Total Debt}}{\text{Total Assets}}$$

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E. Capital Market

Formally the capital market can be defined as the market for a variety of financial instrument (or securities) long term that could be traded, either in the form of debt or own capital, both published by the government, public authorities, and private companies. According to Fabozzi and Peterson (2009:124) "capital market is the sector of the financial market where long-term financial instrument issued by corporations and government trade".

According to constitution No: 8/1995, capital markets is concerned with the activities of a public offering and trading of securities, public companies related to the issuance, and institutions, and professions related to the effect, while the general understanding of capital markets, capital market is an institution or long-term financial instruments transactions.

Based on the physical nature of the capital markets to distinguish between organized securities exchanges (commonly called a stock exchange) which are physically there is a place, such as Indonesia Stock Exchange and the New York Stock Exchange (NYSE). In addition, over-the-counter markets that is physically no place, and includes all effects that are not traded on exchanges.

1. Function of the Capital Market

Capital markets can play an important role in the economic development of a State, a capital markets can function as:

a. A means to raise public funds to be distributed to productive activities.

b. Sources of financing that is easy, cheaper, and fast for the business community and national development.

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c. Encourage the creation of business opportunities and also create employment opportunities.

d. Enhance the efficiency of allocation of resources.

e. Strengthen the operation of financial market mechanisms in managing the monetary system, because the capital market can be a means of "open market operation" at any time is required by Bank Indonesia.

f. Pressing the high level of interest to “rate” a reasonable.

g. As an investment alternative for investors.

2. Stock Exchange

The stock exchange provide the system (market) to bring together exchange is an institution or company conducting, provide the system (market) to bring together offers buy and sales effects between the various companies or individuals involved in order to trade securities firms that have been listed on stock exchanges. According to constitution No: 8/1995, stock exchange is parties has organized and provides a system and the means to bring together the offers buy and sell securities of other parties in order to trade securities among themselves. Therefore, stock exchange is a place to conduct trade activities, where the goods traded in the form of securities (stocks, bonds and others).

The terms of the letter to the company listing on the Stock Exchange:

a. Submit a written request listing to the BAPEPAM.

b. The financial statements must be reasonable unconditionally.

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c. The number of shares listed at least 1.000.000 copies.

d. Amount of shareholders at least 200

e. Company listing policies limit 49%.

f. The company has been operating for more than 3 years.

g. Generate income (operating and net) during the last 2 years.

h. Total wealth of at least Rp. 20 billion.

i. Their own capital of at least Rp. 7.5 billion.

j. Have a minimum paid up capital of Rp. 2 billion.

k. Capitalization of listed shares at least Rp. 4 billion.

l. The Board Notaries and directors have a good reputation.

F. Go Public

Go public is also called the public offering, the activities offerings of the shares or other securities conducted by the issuer to sell shares or securities to the public based on the manner set out in constitution No. 8/1995 capital markets and regulatory implementation.

Some things that must be the reason for the company to implement go public or public offering, in addition to fund raising, the most important considerations are:

1. Increase the ownership of shares for investors' retail.
2. Sell the shares of the company.
3. Looking proceed as much as possible.
4. Create the basis for the distribution in scope of international (for deals abroad).

5. Allocate shares to investors as a long term support.

There are several requirements that must be fulfill by that a company, can issue shares and listed on stock exchanges, including the following:

1. Submit a written request listing to the BAPEPAM.
2. The financial statements must be reasonable unconditionally.
3. The number of shares listed at least 1.000.000 copies.
4. Amount of shareholders at least 200
5. Company listing policies limit 49%.
6. The company has been operating for more than 3 years.
7. Generate income (operating and net) during the last 2 years.
8. Total wealth of at least Rp. 20 billion, own capital of at least Rp. 7.5 billion.
9. Capitalization of listed shares at least 2 billion.
10. The Board Notaries and directors have a good reputation.

The perceived benefits of the company itself, but can be widely felt by society and the State. These benefits include:

1. Improve business efficiency, increase profits and tax receiver.
2. The increasing professionalism of the management company.
3. Increase community participation in ownership of shares large-scale enterprises.

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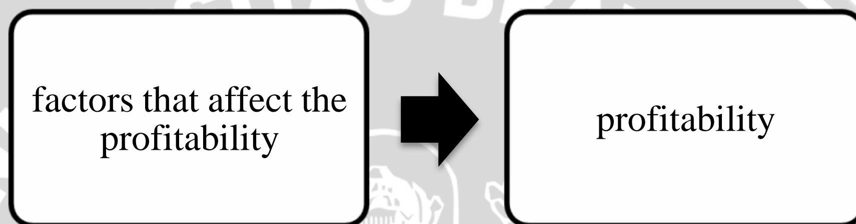
G. Concept and Hypotheses

1. Conceptual of model

Based on the title of the research, formulation of the problem and study of theories about the factors that can affect profitability, it can be arranged conceptual of model as follows:

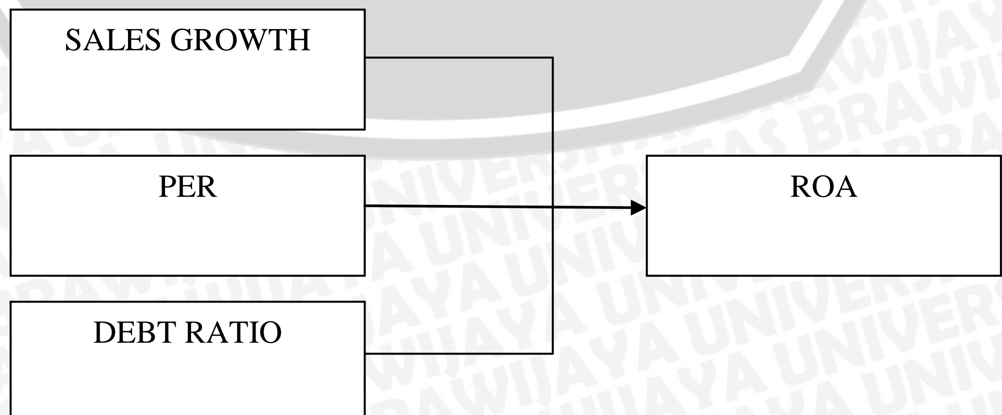
Figure 1 Conceptual of Model



2. Model Hypothesis

Hypothesis is essentially a statement (thesis) that is still not complete (hypo) its truth. In other words the truth of that statement still requires testing. It is to say that hypothesis is a temporary answer to a formulation of research problems. Hypothesis is a statement that are suspected of relationship two or more variables. The model of hypothesis in this research can be described as follows:

Figure 2 Model of Hypothesis



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With reference to the title, formulation of the problem and reviewed the theoretical then obtained the hypothesis model as follows:

a. Sales Growth (X_1), Price earnings ratio (X_2), and Debt ratio (X_3), have an effect on ROA of food and beverage's companies (Y) that to Go Public on Indonesia Stock Exchange period 2008-2010.
b. Sales Growth (X_1) is the dominant variable that affect ROA (Y) food and beverage's companies that Go Public on Indonesia Stock Exchange period 2008-2010.

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