CHAPTER I

INTRODUCTION

1.1 BACKGROUND OF STUDY

Economic growth in Indonesia continues to rise every year. This economic growth is inseparable from all the activities of the company. Increased economic growth can affect the business opportunities of each company, making the company more competitive in maintaining its business sustainability. Therefore, business managers must be able to choose a good step to be taken to maintain the continuity of their business. Some of the steps taken by management in the company are related to the operations of the company. One component of the company that has a major influence on the smooth operation of the company is inventory. According to Syailendra and Rahardja (2014), for companies, inventory is essential, especially in manufacturing companies, since inventory is the main component used by companies to generate sales by managing inventories of raw materials in ready-to-sell finished goods. It is widely believed that a company accumulates the finished goods before selling them to end customers. But the inventory can also describe the raw materials used to produce the finished goods, goods as they go through the production process (WIP), or goods that are in transit (Investing Answer, 2018).

Inventory is the collection of unsold products that are expected to be sold. Inventory is the company's primary factor in supporting the continuity of the manufacturing process in large or small companies. Inventory expenses consist of all purchase expenses, conversion expenses, and other expenses incurred until the inventory is in its current condition and place. These costs can include purchase prices, purchase discounts, taxes, import duties, transport costs, handling costs, costs incurred after purchase or sales such as installation costs, renovation costs, repair costs, and other costs that can be distributed to finished goods, raw materials, and services. Conversion costs include costs involved in managing raw goods into finished goods, such as direct labor costs (IAI, 2014).

As one of the company's major assets, the company must pay attention to what inventory valuation method the company needs to use. Determination of the inventory valuation method will have an impact on the amount of the cost of goods sold which will affect the profits generated by the company and the value of assets in the company's financial statements. Inventory is recorded on a company's balance sheet as a current asset.

The inventory valuation methods may be significantly affecting financial statements especially the company's income statement. The income statement is one of the fundamental information needed by investors in analyzing company performance. With differences in inventory valuation methods will cause differences in profit-loss on the company. Method of inventory valuation can be done in 3 ways, namely FIFO method (First In First Out), LIFO (Last In First Out), Weighted Average Cost method (Kremian, 2012).

The FIFO technique has four significant benefits: (1) it is simple to apply, (2) the assumed cost flow corresponds to the ordinary physical flow of products, (3) it is not feasible to manipulate revenue, and (4) the inventory balance sheet is likely to approximate the current market value. From the FIFO user's point of view, the benefits of LIFO are (1) matching the price of unsold products against revenue, (2) grossly understated inventory, and (3) allowing revenue manipulation.

When a company uses the weighted average technique and rising prices, the cost of the goods sold is lower than that obtained under LIFO but more than that obtained under FIFO. The weighted average costing takes a mid-of - the-road approach. A company can manipulate income under the weighted-average costing method by buying or failing to buy goods near the end of the year (Lumen).

However in Indonesia, according to the Institute of Indonesia Chartered Accountants (2014) stated in PSAK 14 revised 2015 that valuation of inventories must be calculated using the formula of the first-in-first-out (FIFO) or Weighted average cost method. Which is in harmony with after the revision of IAS 2 Inventories in 2003, LIFO was explicitly prohibited to be used by the entities following International Accounting Standards to prepare and present financial statements. PSAK No. 14 states that inventories are reported based on which is lower between the acquisition cost and net realizable value. Net realizable value is the difference from the estimated selling price in business activities which is reduced by the estimated completion costs required to make the finished goods inventory ready for sale. Inventories can be calculated using two methods namely the FIFO method and the average method. The ending inventory value of the FIFO method originated from the most recent cost because the first coming item will be issued or sold first, whereas in the average method, inventory unit costs come from the weighted average of inventory at the beginning of the period and the cost of inventory purchased or produced in a period (IAI, 2014).

According to Syailendra and Rahardja (2014), the use of the FIFO method in assessing inventory will result in higher profits because FIFO produces a high ending inventory value so that the cost of goods sold is small. Whereas in the income statement the use of the average method will produce low profits because the ending inventory value is low so the cost of goods sold is high. Even though the average method has a low profit, the average method has a stable profit and loss.

The existence of two methods that have different influences on financial statements is the basis of the company's consideration in choosing the right inventory valuation method. In determining the valuation of inventories to be used, there are several factors that influence. In this research, the variables that may affect the determination of inventory accounting method are firm size, current ratio, and financial leverage. First, from the previous research by Riswan and Fasa (2016), large companies tend to use the weighted average method. Second, according to Rusher (2016) current ratio is an indicator of a company's liquidity to meet its financial obligation in the near future. Third, if the company's leverage is high, the company is more susceptible to bankruptcy because it is unable to pay the debt, so investors will not be interested in investing and creditors will not want to make loans, the company must have high asset value. In order for the value of high corporate assets, one of ways is to increase inventory value, so the inventory valuation method that companies can use to increase inventory value is the FIFO method, while companies that already have low leverage use the average method (Riswan and Fasa, 2016).

The selection of inventory valuation method by managers of a company can be related to Positive Accounting Theory (PAT). According to Watts and Zimmerman (1986), Positive Accounting Theory (PAT) consists of three theories, which are:

1. Bonus plan theory
2. Political cost theory
3. Debt covenant theory.

It seeks to predict the consequences that occur if the manager of a company chooses certain steps that must be taken by a company. In predicting the influence of steps chosen by the manager, it is based on agency theory, the relationship between managers and other groups such as investors, creditors, auditors, governments, and stakeholders. Managers, do not always align their interests with the shareholders' interest. They either act to increase the company's total value or attempt to increase their personal interests by sacrificing shareholders interests (Brooks and Dunn, 2014).

The sample in this research is consumer goods sector companies. A consumer goods sector is part of manufacturing companies. A manufacturing company is a company which main activities are to process raw materials into finished goods and then sell them. A manufacturing company is any business that makes a finished good using components, parts or raw materials. These finished goods can be sold directly to consumers or other manufacturing companies using them to make another product. It is a commercial enterprise that transforms raw materials or components into finished products. These products are made to meet customers' expectations and demands. This diverse type of inventory requires companies to choose the inventory method well because the selection of inventory methods will have a significant impact on the financial statements (Reference, 2019). Whereas, a consumer goods sector is a category of businesses dealing with items purchased by individuals rather than by manufacturers and industries. The performance in the consumer goods industry is strongly dependant on consumer behavior. Based on (Kardes, Cronley, & Cline, 2013) "all activities associated with the purchase, use and disposal of goods and services, including the consumer's emotional, mental and behavioural responses that precede or follow these activities."

Table 1.1 Current Ratio, Firm Size, and Financial Leverage of Consumer Goods Sector Listed on IDX Year 2013-2017

Company	Year	Current Ratio	Firm Size	Finacial Leverage	Inventory Accounting Method
PT. Gudang Garam Tbk (GGRM)	2013	1.72	17.74	0.42	FIFO
	2014	1.62	17.88	0.43	
	2015	1.77	17.97	0.40	
	2016	1.94	17.96	0.37	
	2017	1.94	18.02	0.37	
PT. Multi Bintang Indonesia Tbk (MLBI)	2013	0.98	14.62	0.45	Weighted Average
	2014	0.51	14.56	0.75	
	2015	0.58	14.64	0.64	
	2016	0.68	14.74	0.64	
	2017	0.83	16.09	0.58	

Source: Prepared by the writer (2019)

Based on the table above PT. Gudang Garam, Tbk applies FIFO for the inventory cost, the current ratio in 2013 was 1.72, decreased to 1.62 in 2014 and increasing in the year of 2015, 2016, and 2017 to 1.77, 1.94, and 1.94 consecutively, this means that the ability of the company to pay was decreasing in 2014 and escalating in the year of 2015 to 2017. The firm size in the year of 2017 was larger than in the year of 2013. The financial leverage in the year of 2013 was 0.42 increased slightly to 0.43 in 2014 and decreasing to 0.40, 0.37 and 0.37 in the year of 2015, 2016 and 2017 consecutively which means the company gradually reduced the use of debt to finance the growth of the company in 2015 to 2017.

PT. Multi Bintang Indonesia, Tbk applies the weighted average for the inventory cost, the current ratio in 2013 was 0.98 decreased to 0.51 in 2014 and increasing in the year of 2015, 2016, and 2017 to 0.58, 0.68, and 0.83 consecutively, this means that the ability of the company to pay debt was declining from the year 2013 to 2014 but gradually increasing in the year of 2017. The firm size in the year of 2017 was also getting larger than in the year of 2013. However, the financial leverage in the year of 2013 was 0.45 also increased to 0.75 in the year 2014 and gradually decreased to 0.64 and 0.58 in the year the consecutive year which means the company also reduced its debt to finance the growth of the company in 2015 to 2017.

From the analysis above, both companies have the same tendencies in increasing or decreasing of current ratio, firm size, and financial leverage. However, the companies choose different inventory valuation method, FIFO method by PT. Gudang Garam, Tbk and the weighted average method by PT. Multi Bintang Indonesia, Tbk.

In addition, there are inconsistencies of the results in previous research, according to Rahmi, Malikah, and Junaidi (2018), inventory variability, firm size, current ratio simultaneously and partially influence the selection of inventory accounting methods in manufacturing companies. Meanwhile, Ayem and Harjanta (2018) stated that firm size, managerial ownership, and financial leverage have no effect on the selection of inventory accounting method. Moreover, the research of Yusuf, Pranaditya, and Raharjo (2017) shows that the ownership structure and leverage ratios have a positive effect on the inventory accounting method but the size of the company's pre-tax profit and the current ratio does not influence the inventory accounting method.

Because of the differences in choosing valuation method even though the companies have similar phenomenon as shown in table 1.1 and inconsistencies of results from the prior research also due to time concern, therefore the writer wants to conduct an analysis on the determinants that affect the selection of inventory valuation method by choosing only current ratio, firm size, and financial leverage as the independent variables due to time concern and the availability of data, titled as **"The Impact of Current Ratio, Firm Size, and Financial Leverage on the Selection of Inventory Valuation Method in Consumer Goods Sector Companies Listed on Indonesia Stock Exchange"**.

1.2 PROBLEM LIMITATION

As the research can be developed into an excessively broad aspect, the writer needs to limit the scope of this research to have clear boundaries. Therefore, this study only focuses on and resolves the problem as follows:

1. The manufacturing companies listed on the Indonesia Stock Exchange for the period of 2013 – 2017.
2. The research only focuses on the manufacturing companies in the consumer goods sector.
3. Independent variables are limited to current ratio, firm size, and financial leverage.

1.3 PROBLEM FORMULATION

Based on the description that has been stated in the background section above, the problems can be described as follows:

1. Does the current ratio significantly affect the selection of valuation method partially?
2. Does the firm size significantly affect the selection of inventory valuation method partially?
3. Does the financial leverage significantly affect the selection of inventory valuation method partially?
4. Do the firm size, current ratio and financial leverage significantly affect the selection of inventory valuation method simultaneously?

1.4 OBJECTIVE OF RESEARCH

The aims of this research are as follows:

1. To find out the significant effect of current ratio on the selection of inventory valuation method partially.
2. To find out the significant effect of firm size on the selection of inventory valuation method partially.
3. To find out the significant effect of financial leverage on the selection of inventory valuation method partially.
4. To find out the significant effect of current ratio, firm size and financial leverage on the selection of inventory valuation method simultaneously.

1.5 BENEFIT OF RESEARCH

The benefits of the research are divided into two types, which are:

1.5.1 THEORETICAL BENEFIT

1. This research is useful for the researcher to have a better understanding of the effect of the firm size, current ratio and financial leverage on the selection of inventory accounting method in a manufacturing company.
2. This research helps readers and future researchers to have more information and wider references.

1.5.2 PRACTICAL BENEFIT

1. For company
   Is useful for a company to asses and select the inventory valuation method.
2. For government
   It is important for the government to monitor and decide which action to take for companies to achieve a fair business in selecting inventory account policy.

1.6 SYSTEM OF WRITING

As the result of data collection as well as to simplify the discussion and understanding of this research, the writer had divided the system of writing into five chapters which are elaborated into the following sections:

CHAPTER I. INTRODUCTION

This chapter consists of the background of the problem that stated the basic idea of what is the reason behind the research is conducted as well as the summary of the variables in both theories and facts. The formulation of the problem consists of the phenomenon occur that is expected to be solved and obtain a solution. It also lists the benefit of why the research is conducted. Lastly, chapter 1 consists of systems of writing that develop the big picture of research writings system.

CHAPTER II. LITERATURE REVIEW

This chapter describes the grand theory, such as agency theory and Positive Accounting Theory (PAT). It also elaborates the theory related to the independent and dependant which are the current ratio, firm size, financial leverage and the selection of inventory valuation method. The theories also need to be obtained from reliable and trustworthy sources. This chapter also consists of researches from the previous researcher that have problem similarities with the writer's analysis.

CHAPTER III. RESEARCH METHODOLOGY

This section describes the concept and methods that are used by the writer to conduct this analysis such as research design, research object, data collection method, and data analysis method. The type of research used in this study is quantitative research.

CHAPTER IV. DATA ANALYSIS AND DISCUSSION

This section describes the general description of the research object and data analysis. In this case, the research discusses the impact of firm size, current ratio and financial leverage on the selection of inventory valuation method by using descriptive statistics, multicollinearity test, overall model fit, goodness fit test, coefficient determination analysis, model of the logistic regression, regression coefficient analysis.

CHAPTER V. CONCLUSION

This is the last chapter of the research that contains the conclusion and the outcome of the analysis results that has through several tests. In this part, it also provides suggestions and recommendations from the problem interpretation.