CHAPTER I
INTRODUCTION

1.1 Background of the Study

Capital structure is really important for companies to be able to maintain a good performance and sustainability. As it matters how the company finances its operations and growth, source of funds should be determined carefully. These source of funds can be either from debt or equity. Goyal (2013) explained that, capital structure decision is critical for any firm for improving firm's ability to operate in a competitive environment and maximizing return to stakeholders. Moreover, managers attempt to verify a particular combination that will maximize profitability and firm's market value, even though generally firms have a choice on how to combine debt and equity (Awunyo-Vitor and Badu 2012).

Capital structure influences whether or not a firm survives in a recession or depression states of the economy and the return a company earns for its shareholders. Capital structure can take the form of equity or debt and it is the percentage of capital at work in a business by type. It is defined as the mix of equity and debt that is used in the firm's operation, a mixture of securities such as use warrants, forward contracts or issue of bond, lease financing, and issue convertible bonds (Kirmi, 2017).

Capital structure is about putting the structure, processes and mechanism in place that can ensure the firm is managed and directed in a way that improves long-term equity value through enhancing organizational performance and managers' accountability. Therefore, a set of rules and incentives are being referred to capital structure in which the company management is being controlled and directed, thus, sound capital structure will have impact on long-term value of the firm for shareholders and profitability. Capital structure and firm's

performance have attract a good deal of public interest as it is a tool for socio-economic development. Likewise, when capital structure and firm's performance are good, there will be an efficient and proper practice in the administration of business entities. The choice between debt and equity for a business firm has implications on firm value as well as strategic importance for corporate managers (Sultan and Adam, 2015).

The need to maximize returns to various organizational constituencies and the impact of such decision has on an organization's ability to deal with its competitive environment make capital structure decision important for any business organization. In order to increase profitability, an appropriate mix of capital structure should be adopted (Shubita and Alsawalhah, 2012).

One of the way to maximize profitability is to increase the assets that a firm has in order to produce more and earn more. Buying more assets means the firm is getting bigger in size as one of the way to measure a firm size is indicated by the amount of assets that a firm owns. Another way to determine the size of firm besides the amount of total assets can be seen through the number of sales and stock market value. In this study the firm size is expressed through the amount of total assets owned by a firm. The higher the amount of the total assets, the bigger the size so the higher the profitability will be. However a research by Sukmayanti and Triaryati (2019) shows negative relationship between firm size and profitability. From this can be said that the impact of firm size on profitability may differ as it depends on the period and the company.

In addition, firm size is a primary factor in determining a firm profitability because of economies of scale. This indicates bigger firms will produce items on a lower costs. Therefore, it can be expected that there is positive relationship between firm size and profitability (Niresh and Velnampy, 2014).

Profitability of a company can be indicated as the ability of a company to earn profit. By deducting expenses from the revenue incurred in generating that revenue, profit can be determined. The amount of profit may be a good measure of the performance of a company, that way profitability can be used as a measure of a company financial performance (AlGhusin, 2015).

The primary objective of a business is profit. In point of view of heavy investment which is necessary for the success of most companies. In accounting sense, profit has a trend to become a long term objective which measures both the success of the product, and also of the development of the market for it.

Profit should be earned by company in order to grow over a long period of time and to survive. It brings evidence concerning how effectively a firm is being managed and the earnings potential of a company. If the company does not earn profit. Capital invested is diminished and if this situation prolongs the company may no longer exist (Amirthalingam and Balasundaram, 2013).

Profitability has given reasonable importance in the finance and accounting literatures. Since one goal of financial management is to maximize the owner's wealth, profitability is one of the most important objectives of financial management and it is a very important determinant of performance. Profitability being defined as a business' ability, whereas it implies the term profit in relation to other elements. To understand how companies finance their operations, it is necessary to verify the determinants of profitability.

Profitability analysis classifies measures and assesses the performance of the company in terms of the profits earned, either in relation to capital employed in the business or in relation to sales, profit or loss or the shareholders' investment. The profit that is earned by a business can be used to measure the success of that investment as

most entrepreneurs invest in order to make a return (Sivathaasan et al., 2013).

Profitability of a company can be influenced by many factors. Many researches shows that firm's size, sales growth, debt to equity ratio, debt to asset ratio, liquidity, tangibility of assets, inventory, and firm's age are being used as the factors that affect profitability. Likewise, by using return on equity (ROE) or return on assets (ROA) as the measurement and indicator of profitability. However, every researches show different results. Some show that there is positive relationship between same variables and some show that there is negative relationship between the same variables in the researches. The only difference is these researches use different object of research.

In this paragraph, there will be an example that will explain the text above. According to (Tailab, 2014a), although the relationship between financial performance of a firm and capital structure can be positive or negative. A research indicates that the majority of empirical studies shows that there is negative correlation between capital structure and profitability. For example, a research found there is negative influence from levels of debt on firms' financial performance. This result was supported by another research which shows negative correlation between profitability and leverage. However a research conducted by other researchers shows that total debt to total assets, short-term debt to total assets, and long-term debt to total assets had positive influence on profitability. This same research also presented that short-term debt to total assets and total debt to total assets had positive impact on ROA in both manufacturing and service industries, while another research indicated that leverage had a negative and significant impact on financial performance.

Given the paragraph above, the writer limits the variables in this research to only short-term debt to total assets ratio, long-term

debt to total assets ratio, firm size and return on assets. This research aims to have a deeper understanding on how capital structure and firm size give impact to profitability and how these three variables have any relations to each other. This study choose pharmaceuticals companies as its object of research for the reason of most listed manufacturing companies (including pharmaceuticals companies) are big in size and needed a lot of funding and to find out the capital structure of pharmaceutical companies.

Table 1.1 Current Liabilities (CL), Non-Current Liabilities (NCL), Short-term Debt to Asset, Long-term Debt to Asset, ROA and Total Asset of Two Pharmaceuticals Companies in the Year 2012-2013 (Expressed in Millions of Rupiah).

Company Name	Year	Capital Structure				Firm Size	Profitability
		CL	NCL	STD to asset	LTD to asset	Tot. Assets	ROA
PT. Darya-Varia Laboratoria Tbk.	2012	191,717,606	41,427,391	0.178	0.039	1,074,691.476	13.9%
	2013	215,473,310	59,878,026	0.181	0.050	1,190,054.288	10.6%
PT. Kalbe Farma Tbk.	2012	1,891,617,853.724	154,695,712.337	0.201	0.087	9,417,957,180.958	18.8%
	2013	2,640,590,023.748	174,513,285.703	0.233	0.089	11,315,061,275.026	17.4%

Source: Prepared by the writer (2019)

The table shows that both companies has increase in current liabilities and non-current liabilities from year 2012 to 2013 which cause the increase in both short-term debt to asset and long-term debt to asset. Increase in both short-term debt and long-term debt to assets might cause the decrease in profitability which is measure by return on assets as shown from the table above. Furthermore, it is also shown that there is an increase in total assets of both companies from year 2012 to 2013. The increase in total assets indicates that there is growth in the size of the firm (company). This might also affect the decreasing return on assets for both companies from year 2012 to 2013.

Based on the table above, the writer would like to analyze the problem that caused the decreasing return on assets (ROA) on these pharmaceuticals companies from year 2012 to 2013. Decreasing ROA can be caused by many things. However in this case, the ROA might decrease because of the increasing of debt from a year to another. This might explains the increasing assets as the companies might borrow money to fund new assets.

Increase in assets could lead to decrease in both short-term debt to total assets and long-term debt to total assets. Likewise, if there are increase in debt that is greater than the increase in assets, this can result in higher debt to total assets ratio and vice versa. Increase in debt to total assets could mean that these companies is using more debt to fund the assets. Therefore, these companies are more exposed to risk.

By this, the writer wish to investigate further whether the effect from using more debt and possessing more assets might directly affect the profitability of companies, which is why the writer decided to conduct the research regarding the effect of capital structure and profitability.

Based on the above background of study, the writer will conduct the research with the title "**The Impact of Capital Structure and Firm Size on Profitability of Pharmaceuticals Companies Listed on Indonesia Stock Exchange**".

1.2 Problem Limitation

The problem limitations of this research are as follows:

1. This study will limit about the impact that capital structure and firm size have on profitability of pharmaceuticals companies that are listed on Indonesia Stock Exchange (IDX).

2. The data will be obtained from annual financial reports of pharmaceuticals companies on both IDX and IDN Financials starting from year 2013 to 2017.
3. The study will focus on short-term debt to assets, long-term debt to assets, firm size and profitability. Both short-term debt to total assets and long-term debt to total assets ratio will be used as the indicators of capital structure and return on assets (ROA) will be the indicators of profitability of pharmaceuticals companies. Capital structure and firm size in terms of total assets are the independent variables of this study. Whilst, return on Asset (ROA) is the dependent variable of this study.

1.3 Problem Formulation

The problem of this study can be defined through the questions below:

1. Does short-term debt to asset partially affect return on asset?
2. Does long-term debt to asset partially affect return on asset?
3. Does firm size partially affect return on asset?
4. Do short-term debt to assets ratio, long-term debt to assets ratio and firm size simultaneously affect return on asset?

1.4 Objective of the Research

The objectives of this research is to study the relationship between capital structure and profitability. The objectives are as follows:

1. To identify whether short-term debt to asset give impact to return on asset partially.
2. To identify whether long-term debt to assets ratio give impact to return on assets partially.
3. To identify whether firm size give impact to return on asset partially.

4. To identify whether short-term debt to asset, long-term debt to asset and firm size give impact to return on asset simultaneously.

1.5 Benefit of the Research

1.5.1 Theoretical Benefit

1. For the writer, considering this research can be a source of knowledge and to deepen her understanding regarding capital structure, firm size and profitability.
2. For future researchers, this research can be used as a guide to conduct further research in the future or this research may be the fundamental idea in conducting future research.
3. For academics, this research can be used as material in teaching other students concerning capital structure, firm size and profitability.

1.5.2 Practical Benefit

1. For Other Researchers, this research can be used to provide additional information and as a reference for further research that will be conducted in the future.
2. For Company, this research may provide help in solving problems related with capital structure, firm size and profitability. Moreover, to understand the influence of capital structure and firm size have on profitability and the importance of optimal capital structure.

1.6 System of Writing

Chapter I- Introduction

This chapter is the introduction of the research and background of study will be the main focus. In this chapter, problem limitation, problem formulation, objective of the research, benefit of the research and systems of writing will be described.

Chapter II- Literature Review

This chapter is the literature review of the research. There will be theoretical background which consists of the grand theory and other theories that is related and will be used in the research. Previous research, hypothesis development, research model and framework of thinking will also be enclosed.

Chapter III- Research Methodology

In chapter three, there are five sub chapter that will be described. They are research design, population and sample, data collection method, operational variable definition and variable measurement, and data analysis method. This chapter is about research methodology.

Chapter IV- Data Analysis and Discussion

Chapter four is about data analysis and discussion. It includes general view of research object and discussion. It also described data analysis which consists of descriptive statistic, result of data quality testing and result of hypothesis testing.

Chapter V- Conclusion

The last chapter is conclusion. In this chapter, conclusion, implication and recommendation will all be described.