CHAPTER I

INTRODUCTION

1.1. BACKGROUND OF THE RESEARCH

In today's complex and ever changing world, business enviroment keeps changing. These dynamic changes affect everything around us like the way we live; which is an essential perspective where all of us are consumers & also potential source of revenue for firms as producers. When we talk about dynamic environment and firms, there is a relationship between them. Dynamic environment will force firms to adapt with it, or else they are going to suffer. Every change affects the capabilities of firm to survive and grow in the middle of competitions. Managers and directors, as the stakeholders, are assigned to manage and set direction to certain point where they are going to bring the firm to reach goals and future objectives. For every decision made, it will bring either good or bad consequences which will affect to overall performance of the firm. To ensure that the firm is walking on the right track, firm's performance needs to be observed and evaluated periodically through various kinds of thorough analysis.

Financial report is a must-have and essential report for every firms, no matter in what industry they are, whatever size they are, either public or private. It is quite helpful to give some general insights about latest financial condition, performance, and consolidation. Simply said, the report indicates whether the firm is in the right track or not. Hence, it is frequently used as a tool to measure firm's success in operating its business model. Numbers, no matter how big they are; can't reflect the true condition. Therefore financial ratios play important role to make the information to be more useful and easily interpreted. In other words, financial ratios are substitutes in observing real characteristics of firm.

The analysis of financial report helps parties, who have interests on the firm, to interpret a lot of connections and tendencies that could become fundamental basis to estimate the future of the firm, either can grow or fail. Phenomenons of firm's failures should be able to be observed through financial ratios, but there are a lot of kinds of financial ratios. Besides that, each calculations on the ratios are based on different purposes. Since there are different types of bankruptcy, then there are different kinds of ratios used for each of them. It comes back to the researcher to decide what are the financial ratios that they are going to use and under what circumstances.

Recently, several failures of firms have shocked people across the globe and helped raising awareness that nowadays, not only small and medium enterprises, but also large corporations are not protected from bankruptcy. The causes of bankruptcy can be varied (systematic or unsystematic) and might cause great structural change in the world economy. As mentioned above, bankruptcy doesn't just show up but it is preceded by financial distress as an indicator. Therefore, financial distress model is very important to be developed. By this, stakeholders will be able to take preventive actions in order to anticipate conditions that might lead to bankruptcy. (Kristijadi and Luciana, 2003)

Indonesia as one of many developing countries in the world has also experienced several times where the firms went bankrupt. As a developing country, Indonesia's economic condition is more vulnerable to dynamic environmental changes. One of serious cases is when the Indonesia banking sector entered restructuring phase after got hit by economic crisis in 1998. Another phenomenon of financial difficulties in Indonesian public companies had been occurred when oil price shock in 2005 and sub-prime mortgage crisis in 2008. These cases lead corporate financial distress of the public companies in Indonesia. In 2005, when Indonesian government reduced subsidy for oil price locally, this made cost of production increased and squeezing profitability. This made many companies in IDX can't perform well. Thus, public companies listed on Indonesia Stock Exchange (IDX) are very sensitive with external factors (Pranowo, 2010).

These phenomena become very important topic for further research. Every party who is related to vulnerability of firms (private, investors, creditors, government) needs to pay attention continuously towards firms latest condition and financial distress analysis will be helpful as a signal for stakeholders to take actions for preventing bankruptcy. Limited amount of literature discussing financial distress in developing countries is an interesting basis point to do this research in Indonesia, since Indonesia was categorized as developing country.

1.2. PROBLEMS STATEMENT

Referred from the background above, this research is intended to have focus on these problems:

1. What are the variables that can explain financial distress condition in manufacturing firms?
2. Which financial ratios that can show financial distress condition in manufacturing firms in Indonesia?
3. What model can be constructed to be used in predicting financial distress in manufacturing firms?

1.3. PURPOSE OF THE STUDY

Based on the problems statement above, this research is purposed for :

1. To find out the variables that can explain financial distress condition in a manufacturing firms
2. To determine financial ratios that can show financial distress condition in manufacturing firms
3. To construct a model that can be used in predicting financial distress for manufacturing firms

1.4. BENEFITS OF THE STUDY

This research was done with some hope that it will be useful as a preceding study for other research in the future time, and helping parties who have interests on certain manufacturing firm, such as:

1. Firms itself, as early warning to help them avoiding possibility of bankruptcy and doing corrective actions as soon as possible.
2. Investors, to help them choosing prospective firms for their investment portfolio.
3. Debtors, as a benchmark for them in measuring the condition of the firm.
4. Academicians, as a preliminary study for future research.