CHAPTER I
INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Along with the increasingly competitive business world in the midst of economic conditions that are always changing, companies are expected to be able to compete in maintaining the survival of their business in the long term period. But in reality, not all companies are able to maintain the viability of their business. So many companies are experiencing difficulties in their business journey which led them to bankruptcy.

According to Rudianto (2013:251), bankruptcy is interpreted as a failure in carrying out its business' operation to achieve its goals. The company is considered to be bankrupt if the rate of return earned by company is smaller than the total cost that incurred in the long term. So bankruptcy does not happen suddenly, and bankruptcy is the accumulation of mismanagement of the company in the long run. Therefore, a tool is needed to detect the potential of bankruptcy that is experienced by the company. The earlier the signs of bankruptcy are found, the better it is for management, because management can take various corrective or improvement steps as preventive efforts. The creditors and shareholders can prepare the company to deal with various bad possibilities that will occur. Financial distress is a stage of declining financial condition before bankruptcy or liquidation.

According to Rudianto (2013:251), financial distress can be interpreted as the inability of the company to pay its financial liabilities at maturity later leading to bankruptcy or liquidity difficulties, as it might be the beginning of bankruptcy.

In Indonesia, there are greater number of companies thriving today, which engaged in the field of industrial, trade and service.

Especially in industrial sector , that has an important role in the Indonesia's economy. In general, the industrial sector contributes greatly to the formation of gross domestic product (GDP), even this sector is rated as motor and pillar of the economic growth in Indonesia. However in this changing economic environment, stocks prices in the basic industry and chemical sectors recorded the sharpest decline. The basic industry and chemical stock index decreased by 2.82% or amounting to -9.605 points (Republika.co.id,2015)

The decrease in the stock index is feared to trigger delisted action upon the basic industry and chemical sector. Based on the trading list of the Indonesia stock exchange (IDX), delisted is often interpreted by investor as an indications of a company going bankruptcy.

Financial distress in this research is measured by Altman Z-Score method. Other of the indicator in predicting financial distress is financial ratio. Financial ratio is a comparison of certain amount to another. By analizing financial ratio, investor can obtain explaination about financial position of a company.

In this research, the first ratio to predict the occurrence possibility of financial distress is liquidity. According to Fahmi (2013), liquidity ratio is the ability of a company to pay its liabilities (short term) and the company's ability to provide funds for its operations. That is, if the company is billed, the company is able to meet the debt, especially debt that has matured. it is able to finance and pay off its short-term liabilities well, then the company's possibility to experience financial distress will be smaller. This research choose current ratio as a measure of liquidity variable. Current ratio is a ratio that measures a company's ability to meet its short term liabilities with its current assets (Brigham and Houston,2010). A company with current assets that is greater than current liabilities is considered in a liquid condition and vice versa.

In addition to the liquidity ratio, leverage ratios can also be used to predict the occurrence of financial distress. According to Keown, as translated by Marcus Prihminto Widodo (2011), leverage ratio represents the level of interest expense incurred by company by using external funds. This refers to trade-off model in which the use of debt at the optimal level can increase the value or profit of the company so that the possibility of financial distress is low.

This research choose debt to equity ratio (DER) to measure leverage variable. Debt to equity ratio is the ratio to measure the level of debt utilization to total shareholder's equity owned by the company. Debt to equity ratio shows percentage of provision of funds by shareholders to lenders. The higher the debt ratio, the lower the company's funding provided by shareholders. So the use of debt can increase the value of company. Increasing corporate value decreases the probability of occurring financial distress.

In this research, firm size is measured by using natural logarithm to total assets. It acts as a control variable with the aim that in the prediction of financial distress in this research is not influenced by factors other than financial ratios. Firm size is scale that indicates the size of company or the company's assets, which can be measured in various ways, including total assets, log size, stock market value, and others (Hidayat,2013). Basically the size of company only divided into three categories, namely large, medium and small companies.

In conclusion, this research uses current ratio, debt to equity ratio and firm size, because these factors are considered to be able to show company's financial performance that affects the prediction of financial distress conditions.

Table 1.1

The Phenomena of Current Ratio, Debt to Equity Ratio, Total Assets and Financial Distress of Basic Industry and Chemical Companies Listed in Indonesia Stock Exchange in period of 2013 – 2016

(In Rupiah)

Nama Perusahaan	Tahun	Current Ratio	Debt to Equity Ratio	Total Assets	Financial Distress
PT.Asahimas Flat Glass Tbk (AMFG)	2013	4.8	0.29	3.539.393.000.000	3.07
	2014	5.69	0.24	3.918.391.000.000	3.33
	2015	4.66	0.26	4.270.275.000.000	2.96
	2016	2.02	0.53	5.504.890.000.000	2.02
PT.Indal Aluminium Industry Tbk (INAI)	2013	13.88	5.07	765.881.409.376	1.19
	2014	12.87	5.16	897.281.657.710	1.44
	2015	9.68	4.55	1.330.259.296.537	1.28
	2016	5.82	4.19	1.339.032.413.455	1.22
PT.Lion Metal Works Tbk (LION)	2013	6.73	0.2	498.567.897.161	3.52
	2014	3.7	0.36	600.102.716.315	2.80
	2015	3.81	0.41	639.330.150.373	2.67
	2016	8.67	0.46	685.812.995.987	2.66

Based on table 1.1, it express a phenomena that occurred in three companies in basic industry and chemical. PT. Asahimas Flat Glass Tbk had current ratio value by 4.8 in year 2013 but it decreased by 0.89 in year 2014. This decreasing values were contrast with the financial distress value 3.07 in year 2013 which increased by Rp. 0.26 in year 2014.

Total assets on PT. Indal Aluminium Industry Tbk had Rp. 1.330, 259, 296, 537 in year 2015 but it increased by Rp. 8,773,116,918 in year 2016. This increasing value was contrast with the financial distress value 1.28 in year 2015 which decreased by Rp. 0.06 in year 2016.

Debt to equity ratio on PT. Lion Metal Works Tbk had ratio 0.2 in year 2013 had increased by 0.16 in year 2014. This increasing values were contrast with the debt to equity ratio by 3.52 in year 2013 which decreased 0.72 in year 2014.

As the explanation above, the author is intrigued to conduct a research titled, **"The Impact of Current Ratio, Debt to Equity Ratio, and Firm Size to Predict Financial Distress on Basic Industry and Chemical Listed in Indonesia Stock Exchange".**

1.2 PROBLEM LIMITATION

This research observe the financial indicators to predict financial distress in basic industry and chemical companies listed on Indonesia stock exchange. Due to time and resources constraint, the object of research is limited to financial distress of basic industry and chemical companies listed in IDX. Futhermore, from all those factors mentioned above, the researcher decides to only focus on current ratio, debt to equity ratio and firm size. The focus of this writing is to understand whether those factors can predict financial distress for basic industry and chemical companies listed on IDX during the year 2013 to 2016.

1.3 PROBLEM FORMULATION

Based on the background that has been disclosed above, then the problem formulation in this research are as follows:

1. Can current ratio predict financial distress of basic industry and chemical?
2. Can debt to equity ratio predict financial distress of basic industry and chemical ?

3. Can firm size predict financial distress of basic industry and chemical ?
4. Can current ratio, debt to equity ratio and firm size predict financial distress of basic industry and chemical ?

1.4 OBJECTIVE OF THE RESEARCH

The objectives to be achieved from this research are as follows:

1. To analyze and determine the effect of current ratio in predicting financial difficulties in basic industry and chemical companies experiencing financial distress that listed in IDX in period year 2013-2016 .
2. To analyze and determine the effect of debt to equity ratio in predicting of financial difficulties in Basic industry and chemical companies experiencing financial distress that listed in IDX in period year 2013-2016.
3. To analyze and determine the effect of firm size in predicting of financial difficulties in Basic industry and chemical companies experiencing financial distress that listed in IDX in peiod year 2013-2016.
4. To analyze and determine the effect of current ratio, debt to equity ratio and firm size simultaneously in predicting of financial difficulties in Basic industry and chemical companies experiencing financial distress that listed in IDX in period year 2013-2016.

1.5 BENEFIT OF THE RESEARCH

Research about the impact of current ratio, debt to equity ratio and firm size to predict financial distress on basic industry and chemical is expected to be useful for all interested parties and besides, this research can give benefit:

1.5.1 THEORETICAL BENEFIT

This research can add a scientific review of financial distress prediction model by using current ratio, debt to equity ratio and firm size.

1.5.2 PRATICAL BENEFIT

Pratically, the research is expected to generate benefits as follows :

1. Company :

   This research can gives understanding about the actual financial condition of the company and can help the company for decision making purpose.
2. Manager :

   It can be used as a foundation in making financial decisions and to prevent bankruptcy.
3. Creditor :

   It can provide consideration in conducting credit assessment, so that lender can provide a certain amount of loans with their current condition.
4. Investor :

   It can provide information in the company's condition so that investors can know where and when they should entrust their investment in a company
5. Academic :

   It can assist the elaboration of knowledge and insight in the classroom and as reference for later research .

1.6 SYSTEMS OF WRITING

To understand more clearly this report, this report is grouped into several sub-chapters with systematic delivery as follows:

1. Chapter 1 (Introduction)

This chapter consists of:

a. Background study, which explains the reason of the research, and the risk that occurs in the company facing face financial distress. It also explains how liquidity ratio, leverage ratio and firm size can predict financial distress in a company.
b. Problem limitation, which states the research boundaries .
c. Problem formulation, which states the research questions examined later in this research
d. Objective of the research, which states the aim of the research.
e. Benefit of the research (theoretical and practical), which explains the possible application of research results and benefits of this research.

2. Chapter 2 (Literature Review and Hypothesis Development)

This chapter consist of:

a. Theoretical background, which is a compilation of related theories as the reference in this research
b. Prior research, which is the statement of prior researches in the relevant topic
c. Hypothesis development, which states the testable relationship of two or more variables as a result of theory viewing
d. Research model, which is a chart intended to prove the truth of the hypotheses
e. Framework of thinking, which is the mindset of researchers linked to the research process

3. Chapter 3 (Research Methodology)

This chapter consists of:

a. Research design, which states whether the research is using qualitative and quantitative method. In this research, quantitative descriptive analysis is used.
b. Population and sample, which explains the entire research subject (population) and part of the entire research subject (sample).
c. Data collection method, which explains the method of collecting research data.
d. Operational variable definition and variable measurement, which explains how a variable is measured (variable definition). In variable measurement, a set of rules are used to transform data into a quantitative one.
e. Data analysis method, which explains the process of transforming raw data to a ready-to-use data.

4. Chapter 4 (Data Analysis and Discussion)

   This chapter consists of:

   a. General view of "Research Object", which is a brief explanation of the research object, or in another words, a general view of the research object.
   b. Data analysis, which displays the result of data analysis conducted in this research.
   c. Descriptive statistic, which are methods of collection and display of data, for example in the form of tables, graphs, etc.
   d. Result of data quality testing, which displays the result of questionnaire-based testing to assure data collected can be accounted for.
   e. Result of hypotheses testing, which is the decision making process resulted from data analysis, whether or not to accept or reject the null hypothesis.

f. Discussion, which is a more detailed explanation of the data analysis results.

5. Chapter 5 (Conclusion)

   This chapter consists of:

   a. Conclusion, which consist of a brief explanation of what was explained in the discussion section.
   b. Implication, which consist of the outcome of this research, whether theoretical or practical.
   c. Recommendation, which consist of advice for external readers as an effect of this research.