CHAPTER I
INTRODUCTION

1.1 Background of the Study

In this globalization era, it is undeniable that business economic has been growing rapidly all around the world, thus increasing the competitiveness of business. Due to that, companies are expected to maintain their financial stability in order to survive in long term. However, there are still a lot of companies that cannot maintain their viability. As the result, bankruptcy becomes the only option.

A well-known example of Indonesian company who declares bankruptcy is PT. Sariwangi Agricultural Estate Agency (SAEA). It was one of the most popular company in Indonesia that produces tea bag. It had been established since 1973 and had to declare bankruptcy on October 17, 2018 by the commercial court Jakarta Pusat. The court stated that the reason of bankruptcy was due to violation of contract with its creditor, PT. Bank ICBC Indonesia. PT. Sariwangi was not able to pay its debt when it was due (Sugianto, 2018).

The bankruptcy news of PT. Sariwangi has become a surprising issue to Indonesian since its products are very well-known. This phenomenon indicates that a company who seems to be doing well can also experiences financial difficulties. The total debt that PT. Sariwangi has to pay to PT. Bank ICBC Indonesia amounted to $20,505,166 US Dollar or around 309.6 milyar Rupiah. The bankruptcy of PT. Sariwangi shows the inability of the company to overcome the financial distress happened in the company (Sugianto, 2018).

Another issue related to financial distress can also be seen from the listing activities in Indonesia Stock Exchange. According to the data reported in Indonesia Stock Exchange (2019), there are thirty-two companies delisted from IDX in the period of 2011 until 2018. A company that fails to meet the standards sets by IDX will be involuntarily delisted. Generally¸ involuntary delistings indicates a company's poor financial health. Alternatively, a company also can voluntarily request to be delisted from a security stock exchange, usually happen when companies was purchased by private firms or merged as a new entity (Husain, 2016).

Table 1.1 Number of Delisting Companies in IDX from 2011-2018

Year	Delisting Companies	Voluntary Delisting	Involuntary Delisting
2011	5	4	1
2012	4	1	3
2013	7	1	6
2014	1	0	1
2015	3	2	1
2016	0	0	0
2017	8	4	4
2018	4	2	2
Total	**32**	**14**	**18**

Source: (Husain, 2016)

As seen from the table, there are eighteen companies that were forced to be delisted from IDX in the year of 2011 until 2018, out of thirty-two companies. This means that there were other companies which are delisted involuntarily compared to delisted voluntarily. The companies which were delisted involuntarily show the failure of the companies to overcome the financial distress condition (Husain, 2016).

Financial distress is a financial difficulties condition experienced by a company due to its inability to meet its financial liabilities. It is usually a stage before a company declares bankruptcy.

A company under financial distress can incur several indirect costs associated with financial distress. When a company is experiencing financial distress, conservative managers may cut down cost of research and development, marketing research, and other investments to save more cash. The firm may also incur opportunity costs if managers invest in risky corporate projects (Yadiati, 2017).

Moreover, financial distress can affect a firm's reputation. A company in financial distress may lose its loyal customers, be forced to pay a higher cost of capital, receive less favorable trade credit terms from suppliers, and be vulnerable to compete with its competitors. Employees of a distressed firm usually have lower morale and higher stress caused by the increased chance of bankruptcy, which would force them out of their job (Kenton, Financial Distress, 2019; Wikinson, 2013)

Financial distress that leads into bankruptcy is generally evidenced long before the event. Early indicators of bankruptcy include decreasing amount of profit, increasing debt, declining number of sales, etc. Due to big impact caused by bankruptcy, such as social and economic problems, bankruptcy prediction has become an important topic in corporate finance literature over the past two decades. However, whether financial distress can lead a company to bankruptcy or not, determining factors influencing financial distress is still highly beneficial for a company considering the losses that would occur under various levels of financial distress (Boentoro, 2016).

Early studies on the prediction of financial distress referred to the use of financial ratios as an assessment tool performance and corporate bankruptcy prediction. The model of financial distress prediction was then developed by Altman in 1968 through Multivariate Discriminant Analysis (MDA) method. The original method uses five types of financial ratios, which are grouped into a Z-score (Rifqi & Kanazaki, 2016).

In addition, several previous researches have been using financial ratios to predict financial distress. Profitability ratios can be used to assess a company's ability to generate earnings from its operation in a specific point of time. It focuses on a company’s return on investment in inventory and other assets. For most profitability ratios, having a lower value relative to a competitor's ratio or relative to the same ratio from a previous period indicates that the company is not doing well.

Another indicator of financial distress is liquidity ratio. Liquidity ratio analyze the ability of a company to pay off both its current liabilities as they become due as well as their long-term liabilities as they become current. These ratios not only show the cash level of a company, but it also shows their ability to convert their other assets into cash to pay off their liabilities. A liquidity ratio of below 1 means a company's short-term assets are not enough to meet its current debt obligations. A company can experience a liquidity crisis if circumstances arise that make it difficult for them to meet short-term liabilities such as repaying their loans and paying their employees (Kenton & Hayes, 2019).

A company’s liquidity problem still can be resolved, as long as the company is solvent. This indicates that leverage ratios can also be used to predict financial distress, as it measures the relative level of debt that a business has incurred and assesses the ability of a company to meets its financial liabilities. Companies relies on a mixture of equity and debt to finance their operations, hence knowing the level of debt held by a company shows whether a company can pay off its debts as they come due and continue its business operations. Generally, a company with a higher solvency ratio is considered to be a more favorable investment (Kenton & Hayes, 2019).

Nevertheless, there are inconsistency in the previous research's result. According to the research conducted by Rezki (2017) and Yadiati (2017), profitability ratio had significance effect on financial distress of a firm, but the research by Boentoro (2016) proved that profitability ratio had no influences on financial distress of a company. Moreover, the research conducted by Pratama (2016) and Boentoro (2015) showed that liquidity and leverage ratio had influences on financial distress of a firm. However, the research by Agusti (2013) showed that only leverage ratio affects financial distress of a company, and there was no effects of liquidity ratio on financial distress of a company. Meanwhile, the research by Tukan (2018) showed that there waas no effect of both liquidity and leverage ratio to financial distress of a company. This shows that there is inconsistent result conducted by previous researchers.

Financial distress can be managed by the management and even better, since its indication can be identified before financial distress occurs. Therefore, the topic of financial distress prediction has become an essential issue needed to be considered. The previous researches used in this research show that profitability, liquidity and leverage ratios are the most commonly used ratios to predict financial distress. Hence, this research will explore further about whether the profitability, liquidity and leverage ratios have influences toward financial distress in manufacturing companies listed in Indonesia Stock Exchange (IDX). The reason for using manufacturing companies as the sample is due to the considerable contribution of manufacturing companies to Indonesia's economic development and GDP growth.

Manufacturing sectors remained a key driver of Indonesia's economy, since it contributed to one-third of overall GDP growth. It brings positive domino effects, such as an increase in value added of domestic raw materials, job opportunities, and foreign exchange earnings from exports. Domestic manufacturing sector also gives the biggest contribution to taxes and excises (Sekretariat Kabinet Republik Indonesia, 2018).

Based on the background of the research explained, the title of this paper will be "**Analysis of Factors Influencing Financial Distress: Empirical Study in Manufacturing Companies Listed in Indonesia Stock Exchange**".

1.2 Problem Limitation

This research is restricted by various constraints, notably the size of companies listed in Indonesia Stock Exchange (IDX). Hence, this research will only focus on factors determining financial distress on manufacturing companies listed in Indonesian Stock Exchange (IDX) in three years from 2016 until 2018. In addition, not all financial ratios are considered in this research, thus the results obtained are based on the financial ratios considered.

1.3 Problem Formulation

Based on the background of this research, the formulation of the research problems are as follows:

1. Does profitability ratio affect financial distress in manufacturing companies listed in Indonesia Stock Exchange (IDX)?
2. Does liquidity ratio affect financial distress in manufacturing companies listed in Indonesia Stock Exchange (IDX)?
3. Does leverage ratio affect financial distress in manufacturing companies listed in Indonesia Stock Exchange (IDX)?

1.4 Objective of the Research

The objectives expected from this research are as follows:

1. To analyze whether profitability ratio affect financial distress in manufacturing companies listed in Indonesia Stock Exchange (IDX).
2. To analyze whether liquidity ratio affect financial distress in manufacturing companies listed in Indonesia Stock Exchange.
3. To analyze whether leverage ratio affect financial distress in manufacturing companies listed in Indonesia Stock Exchange (IDX).

1.5 Benefit of the Research

1.5.1 Theoretical Benefit

The results of this research are expected to provide information and knowledge about factors contributing to financial distress in manufacturing companies listed in Indonesia Stock Exchange (IDX).

1.5.2 Practical Benefit

The results of this research are expected to provide guidance for several agents in society, including investors, bankers, governmental and regulatory bodies, and auditors to identify financial distress of a company. The results of this research are also expected to provide guidance for manager to improve its financial strategy when a company is financially distressed, or even better, to avoid it before it occurs.

1.6 System of Writing

1.6.1 Chapter I. Introduction

This chapter describes the introduction about the research topic, including background of the research, problem limitation, problem formulation, objective of the research, benefit of the research and systems of writing. In the background of the research, it describes a phenomenon of financial distressed companies during financial crisis and its impact on companies listed in Indonesia Stock Exchange (IDX), mainly in manufacturing sector, as well as the result of financial ratio analysis conducted by the previous research. These conditions attract author to conduct further research regarding this topic, which the problem formulation and research objective is both described in this chapter as well. In addition, the writer also included the system of writing which describes an overview of this research's content from the first chapter to the last chapter.

1.6.2 Chapter II. Literature Review and Hypothesis Development

This chapter describes literature review that contains a general theoretical background, equipped with other previous researchers. It also includes hypotheses development, research model, as well as framework of thinking. This chapter uses signalling theory as the grand theory in accordance to the problem of the research. This chapter also explain the theoretical background about financial distress and financial ratio analysis, which then completed with the previous research. The writer also developed the hypotheses, research model and the framework of thinking to further illustrate the research process.

1.6.3 Chapter III. Research Methodology

This chapter describes the methodology used in the research, including research design, population and sample of the research, data collection method, operational variable definition and variable measurement, as well as data analysis method. The purpose of this chapter in to explain about the methodology used in this research.

1.6.4 Chapter IV. Data Analysis and Discussion

This chapter shows the data analysis of the research, including the general description of the research object, data analysis, descriptive statistic, result of data quality testing, and result of hypotheses testing. Finally, it also states the final discussion about the research.

1.6.5 Chapter V. Conclusion

This chapter describes about the ending of the research, consists of the conclusion, which summarize the overall result of the research conducted, implications, as well as recommendation by the writer regarding the research problem.