CHAPTER I

INTRODUCTION

1.1   Background of the Study

No matter how successful a company is performing, failure is still inevitable. The nature of business environment that is changing dynamically is believed to be the major cause of business failure. Both internal and external aspects of business environment are believed to have a substantial impact in determining the continuance of business. Therefore, possessing a deep understanding of the aspects that play a role in leading a company towards bankruptcy is really important.

In running a business, companies must consider many aspects that could influence their business performances. Having a healthy business environment is the utmost importance for a business to continue thriving and competing against its competitors in the industries. There are two factors: internal and external, those make up business environment where each of them forms different threats and opportunities for businesses.

Products, locations, management, resources, and business culture are factors which come from within the company. These factors could be dealt with since the company has some degrees of control over them. On the contrary, government policy, economic conditions, social attitudes, political situations, technological advancement, and market competitiveness are the factors that a company has the least control over since they come from outside of the business (Chapman, et al., 2014).

One of the external factors that concerns businesses the most is the current affairs that is happening domestically or globally. Businesses tend to put a huge amount of attention to current affairs, particularly political related affairs, due to the fact that these matters tend to have a huge impact on businesses. Recently, 2019 Presidential

Election has become one of the most widely discussed current affairs in Indonesia which outcome has captured the attention of investors and businesses both across Indonesia and internationally, mainly because election outcome has a direct impact to a business's shares.

Generally, there would be downfall in stock prices after a certain political event occurs. This situation is deemed to be severe for some companies as they have to face great confusion from within and outside of the firm when a sudden fall in stock prices is not settled. Under these circumstances, shareholders would be the one who suffer the most as the stock that they initially bought has dropped significantly in value.

In most cases, shareholders who become aware of this matter would immediately take some preventive actions to avoid further losses on their assets' net worth. Options that shareholders could take when faced with these situations could be by reducing or withdrawing the amount of their investment in that particular company. This would result in companies having to endure financial difficulties as a consequence of tremendous shortfall of safe funds and causing the business to go into liquidation when they could not fulfill their debt obligations.

Where external factors could impact a business tremendously, internal factors hold the same importance in a way they could adversely affect a business. One of which is the business efficiency in terms of management system in operating and growing their business. According to Karamzadeh (2013), mismanagement is one of the reasons for bankruptcy to occur. "The managerial failures, high costs, financial weakness, ineffective sales activities and high production costs or mixtures of these reasons" (Karamzadeh, 2013, p. 2008) could be an early warning of business failure. Hence, the need for good management system and structure is necessary to protect the companies from undesirable situation.

Up to this time, bankruptcy is still a major threat to many businesses. As stipulated in the Law no. 37 of 2004 article 1 (1), bankruptcy is the confiscation of all the assets of a Bankrupt Debtor whose management and settlement are carried out by the Curator under the supervision of the Supervisory Judge. Based on the understanding above, companies and stakeholders must pay close attention concerning companies' performance as any financial issue that arises might raise the risk of losing all the companies' assets. A comprehensive financial statement analysis could be conducted as a means to investigate financial issues in companies. Thereby, companies are able to detect any indications of business failure.

Aside from analyzing financial statements, one of the most common methods being applied in estimating the probability of bankruptcy of firms is the bankruptcy prediction models which imply financial ratios in predicting bankruptcy. There have been a lot of researchers who have introduced bankruptcy prediction models in history, but none of them agrees on a single best model to accurately predict bankruptcy, especially for manufacturing sectors in Indonesia. For this reason, this study aims to discover the most suitable model to predict bankruptcy for manufacturing sectors in Indonesia. Accordingly, based on the statement above, this study takes the title **"The Analysis of Bankruptcy Prediction Models: A Study of Manufacturing Companies Listed on the Indonesia Stock Exchange (IDX)".**

1.2   Problem Limitation

The focus of this research is to compare five bankruptcy prediction models and analyze which model is the most applicable in predicting bankruptcy potential of listed manufacturing companies in Indonesia. Besides, only manufacturing companies that are listed on the Indonesia Stock Exchange (IDX) are chosen due to a large number of

manufacturing companies in Indonesia. Furthermore, the research period for this study is only limited to 2012-2017.

1.3   **Problem Formulation**

This research intends to find out the best bankruptcy prediction model as a tool to detect early signs of bankruptcy of manufacturing companies in Indonesia. Accordingly, the problem formulation for this research is "Which bankruptcy prediction model is the most applicable to be employed in predicting the bankruptcy of manufacturing companies listed on the IDX?".

1.4   **Objective of the Research**

The specific objective of this research is to find out which bankruptcy prediction model is the most suitable to be employed in predicting the bankruptcy of manufacturing companies listed on the IDX.

1.5   **Benefit of the Research**

Based on the topic discussed above, there are two types of benefits that could be expected from this research:

1.5.1   **Theoretical Benefit**

With this research, additional knowledge about the most suitable bankruptcy prediction model to be applied in Indonesia could be introduced.

1.5.2   **Practical Benefit**

This study is expected to aid every manufacturing companies in Indonesia in analyzing the probability of their companies to experience bankruptcy or business failure. Besides, this research would also help

investors to avoid any possible adverse investments that would inflict financial losses.

1.6   Systems of Writing

This paper is divided into five chapters as follows:

CHAPTER I   INTRODUCTION

The first chapter begins by examining the problem that encourages the author to carry out this research. The problem that initiates this research is about how the continuation of a business entity depends heavily on the external and internal factors. Besides that, the inconsistency of previous research is also the reason for the author to begin this research. This chapter also highlights the scope of this research, the research questions that would be answered through this study, the purpose of this research, the benefits expected from this research, and the summary of each chapter in this research paper.

CHAPTER II   LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The second chapter broadly defines signaling theory, financial reporting, matching principle in financial reporting, financial statement variables and analysis, financial ratios, types of business organization, bankruptcy, liquidation, restructuring, and bankruptcy prediction models. Previous research of bankruptcy prediction models is also being discussed in this chapter. Furthermore, this chapter also outlines the hypothesis development of this study, the research model and the framework of thinking.

CHAPTER III   RESEARCH METHODOLOGY

The third chapter describes the appropriate research design for this study where quantitative research method is implemented and the data would be tested by applying logistic regression model. Furthermore, this chapter also tells about the population and sample of this study, data collection method, data analysis method, operational variable definition and variable measurement.

CHAPTER IV   DATA ANALYSIS AND DISCUSSION

The fourth chapter broadly describes about manufacturing industry in Indonesia. Besides that, this chapter also explains and interprets the data analysis followed by a comprehensive discussion of the research findings that is related to the research questions.

CHAPTER V   CONCLUSION

The last chapter covers the conclusion from the results of the previous chapter where the most appropriate bankruptcy prediction model to be applied on manufacturing companies in Indonesia would then be determined. This chapter also explains the implications from the results of this study and provides recommendations for companies and related parties.