CHAPTER I

INTRODUCTION

1.1 Background of Study

Indonesia's manufacturing sector has faced significant domestic and international challenges in recent years. One prominent issue is how after-tax profit affects the capital structure of manufacturing firms. The COVID - pandemic that has hit the world since 2020 has put great pressure on the manufacturing sector. Factory closures, global supply chain disruptions, and declining domestic and international demand caused many manufacturing companies to experience a decline in revenue. Although Indonesia's economy has shown signs of recovery in 2023 and 2024, the manufacturing sector still faces challenges, including declining purchasing power and fluctuating global commodity prices (www.ekonomi.bisnis.com).

This decrease in demand directly impacts on the company's revenue, resulting in depressed profit after tax. When net profit declines, the company's ability to accumulate internal capital or attract external capital is also affected. In 2024, the Indonesian government faces a major challenge in achieving the tax revenue target set in the *Anggaran Pendapatan dan Belanja Negara* (APBN). Tax revenue from the manufacturing sector decreased by 13.8%, although the sector remains the largest tax contributor in the country. This decline was largely due to tax restitution, where companies filed tax refund claims for losses they incurred. This phenomenon suggests that profit after tax significantly impacts a company's capital structure, as a reduction in profit tends to encourage companies to adjust their capital structure to maintain operational continuity (www.news.ddtc.co.id).

In addition, the manufacturing sector is highly vulnerable to fluctuations in commodity prices. Declining prices of key raw materials such as metals and crude oil reduce profit margins, thus negatively affecting profit after tax. Additional pressure comes from rising inflation, which increases production costs and indirectly affects companies' profitability. With reduced profits, companies are forced to seek external financing to fund their operations, leading to increased leverage in the capital structure (www.ekonomi.bisnis.com).

Company financial management is crucial in operational activities and business development. In managing finances, companies must consider various factors that can influence financial decisions, including capital structure. A company's capital structure refers using financial resources to fund its operations and business development. In this case, the company can use its capital (internal) or foreign capital (external) to meet funding needs. Earnings After Tax (EAT) is important in managing capital structure. Earnings After Tax (EAT) is net profit after fulfilling obligations to all stakeholders except shareholders. Profit after tax can be used as a financial indicator that shows the company's financial performance.

According to (ARIS RIADI et al., 2023) Earnings After Tax (EAT) are the operating profits earned by the company after deducting income tax expenses. Earnings After Tax (EAT) are operating profit minus non-operating income, such as interest income minus corporate income tax. The effect of income tax is proxied in earnings after tax. Earnings After Tax (EAT) already includes the benefit of debt as a reduction in tax expense or the tax factor. According to (Alfandia, 2018) Earnings After Tax (EAT) includes the benefits of debt as a reduction in tax burden. Funding through debt will increase the cost/interest expense, a deduction from taxable income. Thus, the taxable income will be smaller. Earnings After Tax (EAT) is often referred to as net income or net profit. Earnings After Tax (EAT) is an important metric in financial statements because it describes the company's net income for various purposes, such as dividends to shareholders, reinvestment, or reserves.

Capital structure is the ratio between foreign capital and equity capital. Capital structure is the most important issue in making funding decisions. The company implements a capital management strategy to ensure security and its ability to continue its business continuity (going concern). In order to provide benefits to shareholders and other parties, the company maintains an optimal capital structure to minimize the cost of capital. Optimal capital structure is one factor that makes a company competitive in the long run. The optimal capital structure is the capital structure that optimizes the balance between risk and return to maximize the share price. The cost of capital arising from funding decisions is a direct consequence of funding decisions made by managers. With an optimal capital structure, the company will generate an optimal rate of return so that not only the company will benefit, but the shareholders will also benefit (Cahyaning, 2017). Capital structure, which consists of the proportion between equity and debt, plays an important role in corporate financial decision-making. In the manufacturing sector, where capital investment and operating costs are often high, decisions regarding the use of debt or equity are critical. Companies with higher after-tax profits tend to have greater flexibility in choosing funding source, thus reducing dependence on debt andimproving their capital structure. Conversely, when profits decline, many companies are forced to increase the use of debt to meet operational or expansion needs.

In this case, Earnings After Tax (EAT) may affect the capital structure of the company. As the backbone of the economy in many countries, including Indonesia, manufacturing companies often need help managing their capital structure. The firm's earnings performance can strongly influence debt versus equity capital dependence. In the Indonesian context, where the manufacturing sector is strong on the Indonesia Stock Exchange (IDX), research examining the relationship between profit after tax and capital structure is relevant and useful. This research can provide a deeper understanding of the factors influencing capital structure decisions and practical guidance for financial management in managing financial risk and optimizing firm value.

Given the important role of the manufacturing sector in the Indonesian economy, research on the effect of after-tax profit on capital structure is relevant and urgent. A sound capital structure can help manufacturing companies overcome various economic challenges like commodity price fluctuations, inflation, and market uncertainty. Therefore, this study aims to identify how after-tax profit affects a firm's financing decisions and how firms can balance the use of internal and external capital to maximize firm value. This phenomenon is expected to provide a deeper insight into how manufacturing companies can manage their capital effectively amidst the continued economic uncertainty in Indonesia.

Based on theory (Modigliani & Miller, 1958) It examines the optimal capital structure can be achieved when the company's profit is maximized with a minimal cost of capital. This theory states that higher post-tax profits can reduce the need for equity because the company can bear more debt with lower bankruptcy risk. Thus, a capital structure optimally combining debt and equity can increase firm value. In other words, higher profit after tax can be a good indicator because it gives the company flexibility in managing its capital structure. With large profits, the company can rely more on internal funds and less on external debt. One example of a case that can illustrate the impact of Earnings After Tax (EAT) on capital structure is from PT. Unilever Indonesia Tbk (UNVR), one of Indonesia's largest manufacturing companies (www.kompas.com). PT. Unilever Indonesia Tbk is a multinational company that makes beauty and cosmetic products and household needs products in Indonesia. PT Unilever Indonesia is committed to meeting customers' needs and satisfying their products. PT Unilever Indonesia creates value to help it achieve the goals the company has previously set by utilizing consumers, investors, and society. Management makes the right funding decisions for the company to achieve the best performance and maximize its potential. PT Unilever Indonesia continues to increase value in its operations to maintain its existence in the competition. In the world of business competition, Unilever always increases value in all its operations to maintain the company's existence. The source of funding carried out by PT Unilever Indonesia by way of debt and its capital is intended for the company's survival so that it always experiences development in its operations (www.unilever.co.id). As a large company with a significant market share, PT Unilever Indonesia has a strict financing strategy to manage its debt burden and increase its Earnings After Tax (EAT). In recent years, PT Unilever Indonesia has experienced fluctuations in Earnings After Tax (EAT) caused by a decline in consumer purchasing power, which reduced sales, rising raw material costs, which affected profit margins, and pressure from competition, which encouraged the company to allocate more funds to promotion and distribution. When the company's Earnings After Tax (EAT) fell in specific years, PT Unilever Indonesia faced significant pressure to maintain a healthy capital structure. Lower Earnings After Tax (EAT) result in less profit to distribute to shareholders, reducing the company's flexibility in paying debt obligations.

Table 1. 1 Debt and Profit and Loss Data at PT. Unilever Indonesia Tbk for the 2019 – 2023 period (in millions of rupiah)

No	Year	Debt Total	Earnings after Tax
1	2019	15.367.509	7.392.837
2	2020	15.597.264	7.163.536
3	2021	14.747.263	5.758.148
4	2022	14.320.858	5.364.761
5	2023	13.282.848	4.800.940

Source: Annual Report PT. Unilever Indonesia Tbk (processed data)

Based on table 1.1 of PT Unilever Indonesia, it can be clearly seen that debt fluctuates where debt in 2019 towards 2020 has increased by Rp229.755. In 2021 it decreased by Rp850.001. In 2022 it decreased by Rp426.405. Furthermore, in 2023 it decreased by Rp1.038.010.

Total net profit from 2019 to 2023 has decreased every year, in 2019 towards 2020 it decreased by Rp229.301, in 2020 towards 2021 it decreased by Rp1.405.388, in 2021 towards 2022 it decreased by Rp393.387, and in 2022 towards 2023 it also decreased by Rp563.821. The reason for choosing PT. Unilever Tbk because PT. Unilever Indonesia is a manufacturing company whose products are so needed by the public and is one of the manufacturing companies so attractive to investors. The case of PT. Unilever Indonesia Tbk illustrates how Earnings After Tax (EAT) affects management decisions regarding the company's capital structure. When Earnings After Tax (EAT) decreases, companies are more cautious in taking debt and focus on reducing operating costs. Conversely, when Earnings After Tax (EAT) increases, the company is more flexible in managing capital structure, including increasing debt and capital expenditure to support further growth.

Based on research (Alfandia, 2018) the results showed that Earnings After Tax (EAT) negatively affects leverage proxied by Debt to Equity Ratio (DER). Despite generating high earnings after tax, the company chooses to increase debt as part of its funding strategy. This could be because the company wants to utilize financial leverage to increase return on equity. In other words, increasing Earnings After Tax (EAT) motivates firms to use more debt because firms consider leverage as a tool to accelerate growth or increase return on equity, even though this may increase financial risk.

Based on research (ARIS RIADI et al., 2023) the result shows that Earnings After Tax (EAT) negatively affects the capital structure, which means that the increase in Earnings After Tax (EAT) is associated with a decrease in the proportion of debt in the capital structure. This shows that companies with higher earnings tend to reduce dependence on external funding (debt) and prefer to finance their operations using internal funding from the profits generated.

Table 1. 2 The Phenomena of Earnings After Tax and Debt Equity Ratio in Manufacturing Sector on the Indonesia Stock Exchange from the period of 2021 - 2023 (in millions of rupiah)

Company	Year	Earnings After Tax	Debt Equity Ratio
PT. Alkindo Naratama Tbk (ALDO)	2021	0,0791	0.7214
	2022	0,0935	1.0503
	2023	0,0536	1.1628
PT. Sariguna Primatirta Tbk (CLEO)	2021	0,1349	0.3461
	2022	0,1572	0.4806
	2023	0,1377	0.5161
PT. Delta Djakarta Tbk (DLTA)	2021	0,0741	0.2955
	2022	0,1320	0.3062
	2023	0,1573	0.2928
PT. Steel Pipe Industry of Indonesia Tbk (ISSP)	2021	0,0749	0.8741
	2022	0,0519	0.7869
	2023	0,0743	0.7261

Source: Prepared by the Writer (2024)

Table 1.2 provides a comprehensive overview of Earnings After Tax (EAT) and Debt Equity Ratio (DER) in manufacturing sector companies listed on the Indonesia Stock Exchange for 2021 - 2023. The data underscores noteworthy differences in earnings after tax to debt equity based on the manufacturing sector company industry phenomenon.

In the table, in the same year, ALDO experienced an increase in EAT from 2021 - 2022 and decrease in 2023. And the debt-to-equity ratio experienced an increase from 2021 – 2023, low profits indicate that the company has limited profit capacity, which has an effect on the company's ability to finance operational activities. When profits are low, companies are more prone to the portion of debt in their capital structure, which adds to financial risk. In addition, reliance on debt as a funding source can also create investor distrust of the company's stability.

The table also shows that CLEO experienced an EAT increase in 2021 – 2022 and decrease in 2023, but the company's nominal DER continued to increase from year to year. This shows that CLEO always makes a profit yearly but pays little attention to its debt. In other words, CLEO utilizes debt to increase profits without a top priority for debt repayment; this is not good for the company's capital structure because the company prioritizes dividend distribution over debt repayment.

It was also noted that the DLTA company experienced an increase in EAT from 2021 - 2023. In 2021 - 2022, DLTA experienced an increase and has decrease in 2023. This shows that DLTA has a stable capital structure recording.

The ISSP company experienced a decrease in EAT in 2021 towards 2022 and increased again in 2023. And decrease for DER in every year. However, the DER value of the DLTA company continues to decline, which shows that ISSP prioritizes debt payments over dividend distribution so that the ISSP company shows good financial risk management.

The novelty of this research shows and focuses on the manufacturing sector in Indonesia by holding control variables so that not many variables can affect the main variables using the purposive sampling method, which obtained a total sample of 304 data and outliers until 208 data remained. This study covers 2020 - 2023, providing the latest and most relevant data. contrast to previous research (ARIS

RIADI et al., 2023), which focuses on the relationship between Earnings After Tex (EAT), Corporate Tax Rate and Non-Debt Tax Shield on Capital Structure in manufacturing companies with the mining sector listed on the IDX for the period 2012 - 2017 with a total sample of 36 data from 6 companies there is an influence from other variables. Based on the considerations described earlier, the researchers conducted research titled **"THE EFFECT OF EARNINGS AFTER TAX (EAT) TOWARDS CAPITAL STRUCTURE"**.

1.2 Problem Formulation

Based onthe background of the study, the problem formulation for this study is as follow:

1. Does Earnings After Tax (EAT) effect Capital Structure?

1.3 Object of the Research

This study examines whether Earnings After Tax (EAT) effect the Capital Structure of manufacturing companies listed on the Indonesia Stock Exchange (IDX) in the period 2020 - 2023.

1.4 Benefit of Research

1.4.1 Theoretical Benefit

Based on research objectives, this research can be used as a reference for future researchers in further research related to the development of accounting science, especially the implementation of Earnings After Tax (EAT) on Capital Structure. In addition, this research is expected to contribute to developing theories regarding the effect of

Earnings After Tax (EAT) on the Capital Structure of manufacturing companies in Indonesia.

1.4.2 Practical Benefit

Based on research objectives, the research is expected to provide practical benefits as follows:

1. For Academic: Adding to the academic literature regarding the effect of Earnings After Tax (EAT) on Capital Structure in the manufacturing sector in Indonesia and can also be used as a source of information and a reference to add much knowledge related to the effect of Earnings After Tax (EAT) on Capital Structure in manufacturing companies in Indonesia.
2. For Practitioners: Providing insight for corporate finance managers in making strategic decision related to capital structure for the Company's continuity, primarily related to the effect of Earnings After Tax (EAT) on Capital Structure manufacturing companies.

1.5 Problem Limitation

Researchers apply problem boundaries to limit the discussion of the subject matter so that there is no problem expansion. The limits that have been determined and made by researchers in this study are follows:

1. This observation uses research objects in the form of companies listed on the IDX in the 2020-2023 period.

2. The population used is all manufacturing sector companies registered and listed on the IDX during 2020-2023.
3. This study used Capital Structure as the dependent variable and Earnings After Tax (EAT) as the independent variable.
4. This study used Liquidity, Firm Age, Firm Size, and Sales Growth ascontrol variables.