CHAPTER 1

INTRODUCTION

1.1 Background

According to Keown et al. (2001), the goal of a firm is maximization of shareholder wealth. Not only this goal be in the best interest of shareholders, but it will also provide the most benefits to society. In order to achieve this goal, a firm will need resources directed to productive use by business.

Finance is the most significant factor that assists in the formation of new businesses, and allows businesses to take advantage of opportunities to grow, to expand or innovate further. As the old proverb says it takes money to make money, the firm sure will need to buckle down and spend money in order to operate. In the language of finance, the business should make investments in assets such as inventories, machineries, lands and labors, in order to generate cash.

There are two kind of sources of financing, first debt financing and the second is equity financing. Debt is any external funding which is repayable and has an associated cost. The cost may be direct such as interest payment or indirect such as agency cost. Debt could be short term (less than one year) or long term (more than a year).

Firms may use different forms of debt such as taking a credit facility directly from a financial institution, issuing (warrants or convertible) bonds, using lease financing or taking a trade credit to finance their business. Debt may also be more complicated, for example by using derivative instruments such as futures and forward contracts or by using swaps. The debt equity mix constitutes the capital structure of the firm (Brealey et al. 2008).

Modigliani and Miller (1958), popularly referred to as MM, published what has come to be known as the modern theory of capital structure. MM demonstrated under a very restrictive set of assumptions that a firm's value is not affected by its capital structure. This assertion by MM is based on some assumptions including the absence of taxes, market participants can borrow or lend at risk free rate, there are no brokerage or transaction charges, and no bankruptcy cost among others. MM therefore, by implication, point out that in real world, factors such as taxes and interest rate payment affect the debt equity composition of a firm's capital and the value of a firm. Since then, the study of capital structure and its debate has received a lot of attention from academicians, researchers on finance, financial analysts and practitioners. However, most of these studies has occurred in the developed countries or in the developed economies.

Another theory on capital structure popularized by Myers and Majluf (1984), is the pecking order theory. It explains that corporate financial managers follow a certain order or sequence of financing sources when funding a project. Internal fund would first be used when available, and when it becomes scarce, they resort to debt until it becomes financially and economically, not advisable to hold any additional debt, then the last recommendation is issuing equity.

Based on the above background, obtained a description of various influence posed by capital structure to company's profitability. Therefore, this research must be done to analyze and reexamine the relationship of capital structure variables and profitability that has been done by previous researchers with supported theories.

This research is performed to investigate the relationship of capital structure and profitability on telecommunication companies listed in Indonesia Stock Exchange during

2011-2015. Author perceive the need to do analysis on this sector because this is one of many industries that continues to grow.

Telecommunication company is one of the most dynamic companies. In Indonesia, telecommunication companies are continues to experience rapid growth along with the development of information and technology. According to the directorate general of post and telecommunications, over the period 2006-2010 the average growth of mobile phone users in Indonesia is 31.9% per year. Until the end of 2010 the number of mobile phone users has reached 211 million users that consisted of GSM operators by 95% and 5% of CDMA market.

Profitability variable is measured by profitability ratio, return on equity (ROE), while the capital structure is measured by short term debt, long term debt and equity. To focus the problem, researcher will focused only on some companies engaged in the field of telecommunications are actively traded on the Indonesia Stock Exchange 2011-2015. The companies are PT. TELKOM Tbk, PT. Indosat, Tbk,PT. XL AXIATA, Tbk and PT.Smartfren Telecom Tbk.

1.2 Problem Statement

Since Modigliani and Miller (1958), came out with their theory on capital structure, many researchers in finance carried out several studies on the relationship between capital structure and firm’s performance or profitability. However, most of these studies have been done in developed countries where economic conditions are relatively stable such as the United States and Britain. In Indonesia where business economic environment are relatively volatile, scholars and researchers in finance have also carried out some studies on capital structure and its relations to firm’s performance or profitability to find out whether their findings would be consistent with those in the developed economies.

Relationship between capital structure and profitability cannot be ignored because the improvement in profitability is necessary for long-term survivability of a firm. According to Indonesia's accounting standards, debt interest expense included into the type of expenses that reduce gross income and ultimately reduce amount of tax that should be deposited.

PSAK 1:56 concerning about the presentation of the income statement report should include the following items: revenue, profit and loss of business, cost of borrowing, part of the profit or loss of affiliated companies and associations that are treated using the equity method, tax expense, profit or loss from ordinary activities, extraordinary items, minority interest and net profit or loss for the current period. The addition of debt in capital structure will improve profitability of a firm. Therefore, it is important to test the relationship between capital structure and profitability of the firm to make sound capital structure decisions, because the composition of capital structure will affect the company's profitability.

So many studies have provided the evidence that capital structure does affect profitability. For example research conducted by Umar (2012) found that there is a negative relationship between capital structure and profitability, while Nirajini and Priya (2013) and Vatavu (2015) found a positive relationship between capital structure and profitability. However, the analysis over the influence of capital structure and profitability in one single research is limited and showing not consistence result. An opportunity to perform additional research among those variables is open in the form of replication and development.

Related to the reason above the researcher want to conduct research on the use of capital structure as financing media by the investor in Indonesia, especially in telecommunication companies listed on Indonesia Stock Exchange in 2011-2015. Researchers want to analyze the extent of pattern influence of capital structure on profitability, than the formulation of problem posed by the researcher is

"To what extend the long term debt and short term debt as well as the equity influence the profitability in telecommunication companies listed in Indonesia Stock Exchange in 2011-2015?"

1.3 Research Purposes

Based on the background and then identified in problem formulation, the study aims to:

1. To examine the effect of short term debt/liabilities on the firm’s profitability

2. To examine the effect of long term debt/liability on the firm’s profitability

3. To examine the effect of equity on the firm’s profitability

1.4 Writing Systematic

CHAPTER I	is an introductory chapter, which describes the background problems, problem statement, purpose and usefulness of the research and systematic writing in this research.
CHAPTER II	Discusses the literature review that begins with basic theories related to the study, similar research history, framework, and formulation of hypotheses to be tested for ease in understanding about this research.
CHAPTER III	Elaborating on the research method contain variables use, operational definitions, sampling, kind and data sources, as well as the methods of analysis used in research.

CHAPTER IV Explaining about the description of the object of research, data analysis, and discussion so that can know results of the analysis examined the results of hypothesis testing.

CHAPTER V is a concluding chapter that presents a brief conclusion obtained from the analysis in the previous chapter, limitations of the study, and suggestions for research that will come.