CHAPTER 2
LITERATURE REVIEW

2.1 Introduction

This chapter is intended to review the existing literature regarding the factors influencing stock return. It begins with a review of the relevant empirical studies and theoretical underpinning for the research. This chapter is concluded by developing a suitable conceptual framework and hypotheses for the research.

2.2 Empirical Review

2.2.1 Empirical Review of Stock Return

Stock return is the result of stock trading or investment activity in a specific time period, which results in either a capital gain or a capital loss (Noviyanti & Firnanti, 2022). A stock return is an investor's return on investment in the form of potential future earnings (Scott, 2015:133; Brigham & Ehrhardt, 2017:242). According to Subramanyam (2009:16), return on investment is the right of investors to company income which can be in the form of distribution of profits or profits that are reinvested in the company.

Stock return is divided into two categories, one is realized return and another one is expected return. According to Cahyani and Sembiring (2019), realized return is computed and determined using historical data. Moreover, this return is one of measurements for company performance while good company performance indicates the ability of company to achieve their goals. When a company makes an investment in fixed assets, a profit is to be expected, however when a company purchases ordinary shares, a dividend payment and capital gain are to be anticipated as results. When company has high stock return, it will attract more investors to invest their money. Stock returns are the profits investors get from purchasing and selling stocks on the stock market. Consequently, it is possible to comprehend these returns as the result of the price discovery mechanism (Bansal et al., 2021). There are many variables that could influence the price discovery process. According to Subramanyam (2009:16), return on investment is the right of investors to company income which can be in the form of distribution of profits or profits that are reinvested in the company. According to Subramanyam (2009:16), investors are to provide the company's operational financing funds for investment purposes and to get a return on the investment after considering the expected rate of return and investment risk.

2.2.2 Empirical Review of Earning Information

Earning information is an indicator of the wealth created by an entity over the course of an accounting period. Accounting profit, another name for earnings information, is a beneficial metric for measuring business performance. As a result, accounting earnings should be taken into account when investors and creditors model their decisions (Santosa, 2011). Accounting profit, or net income change as a percentage, is calculated as net income for a period less net income for the prior year, divided by net income for the prior year.

International Accounting Standard 12 stated that accounting profit is profit or loss for a period before deducting tax expenses. Accounting profit also defined as the difference between the revenue realized from the transactions that occurred during a period and the expenses associated with that income. Because of a window dressing approach or financial statement manipulation by the company, investors may do not receive reliable financial statement information to use as a reference for decision-making.

Financial statements are intended to provide a precise standard for assessing the financial performance of the company. Profits or income are one of the factors that can be considered as a parameter. The bigger the net profit obtained, the better the company's performance. The firms' methods for managing their earnings have an impact on stock returns. International experts have long been interested in examining the connection between accounting earnings and stock returns.

2.2.3 Empirical Review of Cash Flow Components

Cash flow statement is a summary of the company’s cash receipts and disbursement in a certain period. Cash flow statement consists of three (3) activities as follows:

2.2.3.1 Empirical Review of Operating Cash Flow

Operational cash flow is the cash flow that enters or leaves the determination of net income and is derived from the company's primary revenue-producing operations or transactions. Because the company can create a significant amount of earnings from operating activities alone, the increased cash flow from operating activities indicates that the company may operate profitably (Yocelyn and Christiawan, 2012).

Operating cash flow is produced by the company's operational activity. The ability of a company to create sufficient cash flow from running activities to pay loans, assess its operational capability, pay dividends, and make new investments without relying on external funding sources can be determined using information from operating cash flow (Kasmiati and Santosa, 2019).

2.2.3.2 Empirical Review of Investing Cash Flow

Cash flows from investing operations can be considered by investors when assessing the company's performance in future. Companies with declining cash flow from investing activities, which indicates that there is investment activity, shows the potential for subsequent income growth from new investments. Investors can use this information to help them determine whether to buy or sell their shares by using it as a reference.

The stock prices and stock returns may then change as a result of an investor decision (Yocelyn and Christiawan, 2012). Investing cash flow reflects on cash receipt of the company and expenditures from investing activities to generate company’s income. Theoretically, the cash flow of investment companies with the high investment will lead to investor confidence in the company, so the greater the stock returns.

2.2.3.3 Empirical Review of Financing Cash Flow

Investors use the company's cash flow from financing activities as a parameter when assessing it, which affects their investment decisions. Also, the demand for and supply of company shares will be impacted by investors' investment choices, which will change stock market prices and stock returns (Yocelyn and Christiawan, 2012).

According to Weygandt et al. (2015, 646), financing cash flow is derived from cash receipts and payments made by the company's financing activities. It involves generating cash through the issuance of debt and paying back the amount that the company borrowed from other parties. Additionally, it engages in activities to collect cash from shareholders, repurchase the cash, and pay dividends. By concentrating on abnormal trading volume and price reaction to CFRs, Alfonso et al. (2018) analyzes the determinants of cash flow restatements (CFRs), investors' mixed views about CFRs, and the information content of CFRs. According to Alfonso et al. (2018), investor dissatisfaction with CFRs can be seen in increased abnormal trading volume and an incremental volume response to changes in operating cash flows following the SEC allowance period.

2.2.4 Empirical Review of Financing Decision

The financing decision, as leverage in this research, is measured using Debt to Equity Ratio (DER). The choice of the company's financing's composition is referred to as the financing decision (Brigham and Houston 2016; Finishtya 2019). A company's decision of financing can have an impact on its stock return. Long-term financing sources like the issuing of shares, bonds, and retained earnings are used to finance the money required for capital expenditures (Kasmiati & Sentosa, 2019). Both internal and external businesses provide financial support to the corporation. According to Van Horne and Wachowicz (2009), internal finance refers to funding that originates from within the business in the form of retained earnings, whereas external financing refers to funding provided through debt, equity, and hybrid securities.

A financing decision, often known as a debt policy, defines how much debt financing a company needs (Herawati, 2013). Finance decisions have a direct impact on the financial performance and capital structure of the company, making it one of the most important and difficult tasks for financial managers (Kumar et al., 2012). Choosing the best capital structure for the business is related to the financing decision. The goal of the financing decision is to discover the best source of capital to finance different investment options in order to maximize the company's value, which is represented in the share price.

2.3 Underpinning Theories

2.3.1 Signal Theory

This signaling theory was developed by Spence, who published a research titled Job Market Signaling in 1973. According to Spence (1973), the labor market is characterized by asymmetries in information. Spence developed a signal criterion as a result to strengthen decision-making. Signal theory is a management action that informs investors about how management views the company's prospects. The theory provides an explanation for why businesses believe the need to communicate with or give information about their financial statements to other parties. Because there is information asymmetry between corporate management and outside parties, there is a desire to submit or disclose information about financial reports to them (Bergh et al., 2014). Compared to outside parties like investors, creditors, underwriters, and other information consumers, the firm or corporate management is better informed about the activities and future prospects of the company.

A signal or signal is an activity done by the company's management that informs investors about how management views the company's prospects. According to this assertion, businesses with promising futures will want to avoid selling their stock in favor of seeking additional capital gains through other channels, like the usage of debt that exceeds the typical capital structure aim. In contrast, organizations with poor prospects will typically sell their stock. In other words, a company's announcement of the issuance of shares is a sign or signal that the management of the company sees the company's prospects as dim, and if a company offers the sale of new shares more frequently than usual, the company's stock price will decrease because by issuing new shares it gives a negative signal that can then depress the share price (Przepiorka & Berger, 2017).

The correlation between this theory and the topic of this research is that companies utilize their financial statements to communicate with investors about their financial condition in order to make decisions regarding future investments, whether it be a positive or negative signal. According to Hasyim and Ardityasari (2020), the market will respond to the report's positive value. Investors will put their money into companies they believe can offer more investment returns. Therefore, the company that is able to create positive return means the company has good asset management. Changes in share price when the information is announced can be an indicator as market reactions. The reason is because the participants in the market receive the information and interpret also analyze it as good or bad news. If it is considered as good news, then the demand of shares will increase and will be followed by increasing in stock price and stock return (Noviyanti & Firnanti, 2022).

2.4 Research Hypotheses Development

The purpose of this research is to identify the factors that influence the stock returns of Indonesian consumer non-cyclical companies. For this purpose, hypotheses were developed based on the conceptual framework identified in the previous section.

2.4.1 Earning Information and Stock Return

The first study to show a connection between accounting earnings and stock return was done by Ball and Brown in 1968. Numerous studies have since been carried out to study the subject.

Most association studies have looked at samples of businesses listed on developed capital markets (Easton and Harris, 1991; Booth et al., 1997; Ball and Shivakumar, 2008; Clout and Willett, 2016; Okafor et al., 2016; Tahat and Alhadab, 2017; Elbakry et al., 2017; Chen et al., 2020; Shan and Troshani, 2020), and discover that greater earnings levels and larger earnings changes are linked to higher stock prices and returns. However, it appears that there are no differences between developed and developing economies in the relationship of earnings with stock prices and returns (Vafeas et al., 1998; Chen et al., 2001; Sami and Zhou, 2004; Dimitropoulos and Asteriou, 2009; Chamisa et al., 2012; Kargin, 2013; Black and Maggina, 2016; Melgarejo et al., 2016; Outa et al., 2017; Khidmat et al., 2019; Melgarejo, 2019; Bashir et al., 2021; Roca, 2021; Srivastava and Muharam, 2021).

According to Mutia (2012)'s analysis of the impact of earnings information on stock prices, earnings have a sizablely beneficial impact on stock prices. The same findings are confirmed by Paradiba (2015), who also looks at the impact of net income on stock prices. Operating income has a significant impact on stock prices. In other words, stock returns are positively impacted by good news about corporate earnings (Ball, Gerakos, Linnainmaa, and Nikolaev 2015; Charitou et al. 2000; Chen, Chen, and Su 2001; Novy-Marx 2013).

However, there are conflicting findings regarding the impact of accounting earnings on stock returns. Salehi, Tagribi, and Farhangdoust (2018) examine how the Tehran Stock Exchange-listed companies' earnings quality and the quality of their financial information disclosure affect stock returns. Theoretically, if the company produces a bigger profit, then the company will be able to distribute increasingly large dividends and will positively influence stock returns.

H_1: *Earning Information influences stock returns*.

2.4.2 Operating Cash Flow and Stock Return

Ball et al. (2016) and Foerster, Tsagarelis, and Wang (2017) mention that operating cash flows provide investors with better information than accrual accounting does. The investor confidence in the company's worth increases as operating cash flow does, leading to greater stock returns. According to Harahap and Effendi (2020), Ernayani et al. (2018) and Putra and Widaningsih (2016), there is positive correlation between operating cash flow and stock return. Operating cash flow, however, was found to have little impact on stock return in studies by Yuliarti and Diyani (2018) and Sitorus et al. (2021). It implies that the information regarding operating cash flow is not taken into account by the investors.

H_2: *Operating cash flow influences stock returns.*

2.4.3 Investing Cash Flow and Stock Return

According to Yuliarti and Diyani (2018), the return on a company's stock is unaffected by cash flow from investing activities. Investment operations include the buying and selling of fixed assets as well as other investments. But because it is not routine and might happen just once a year, it is not really affecting the company profit. Thus, it will not affect the company stock return. The findings of Cahyani and Sembiring (2019) and Ernayani et al. (2018) are consistent with this.

But Kasmiati and Santosa (2019) pointed out that investment cash flow has a negative effect on the company's stock return. Harahap and Effendi (2020), Nurchayati and Nasaroh (2017), and Putra & Widaningsih (2016) all claimed that cash flow from investing operations has a significant impact on stock return. Investors react to an increase in investment cash flow and consider this when choosing an investment.

Research was conducted by Khanji and Siam (2015) using investment cash flow as the independent variable and stock price as the dependent variable. The stock price in this study is not significantly impacted by investment cash flow. According to Mutia (2012), it shows that the cash flow component of investment activities has an influence on stock returns.

Using balance sheet data, Weber (2018) develops a measure of cash flow duration at the firm level and discovers that only returns with short sales restrictions exhibit the negative cross-sectional association between cash flow duration and returns. Investment cash flow has been shown by Ernayani and Robiyanto (2016) to have a negative impact on stock returns. This explanation leads to the conclusion that investment cash flow has a negative impact on stock returns.

H_3: *Investing cash flow influences stock returns*.

2.4.4 Financing Cash Flow and Stock Return

According to Kasmiati and Santosa (2019), financing cash flow has a positive influence on a company's stock return. If a business generates a significant cash flow from financing activities, this may be a sign that it will eventually be more profitable. The company stock return will increase as a result. This is in line with Putra and Widaningsih (2016), Harahap and Effendi (2020), and Nurchayati and Nasaroh (2017) that also stated there is positive relationship between financing cash flow and stock return.

But according to Yuliarti and Diyani (2018), financing cash flow has a negative impact on a company's stock return. This dividend payment is shown by the rising cash outflow from financing activities. Therefore, a low cash flow from financing activities will result in an increase in the company's stock return.

According to Ernayani et al. (2018) and Nurmalasari and Yulianto (2015), financing cash flow has no influence on company stock return.

H4: *Financing cash flow influences stock returns*.

2.4.5 Financing Decisions and Stock Return

Carvalho (2018) presents evidence for this effect by examining how long-lasting shocks to the value of a firm's tangible assets (real estate) impact the volatility of those assets' subsequent stock prices. Concerns about the identification of these balance sheet impacts are addressed by the analysis, which also demonstrates that these effects are consistent with larger patterns regarding the equity volatility of R&D-intensive enterprises. According to Kasmiati and Santosa (2019), financing decision as measured by debt to equity ratio has a negative effect on stock return, the results indicate that the higher the debt ratio, the lower the stock returns. The results of Kumar, Anjum, and Nayyar (2012), which mentions a positive relationship between financing decisions and stock returns. They state that when a company used debt, the value of the company increases because of the effect of the tax-deductible, which can provide benefits for shareholders (Rakhimsyah and Gunawan, 2011).

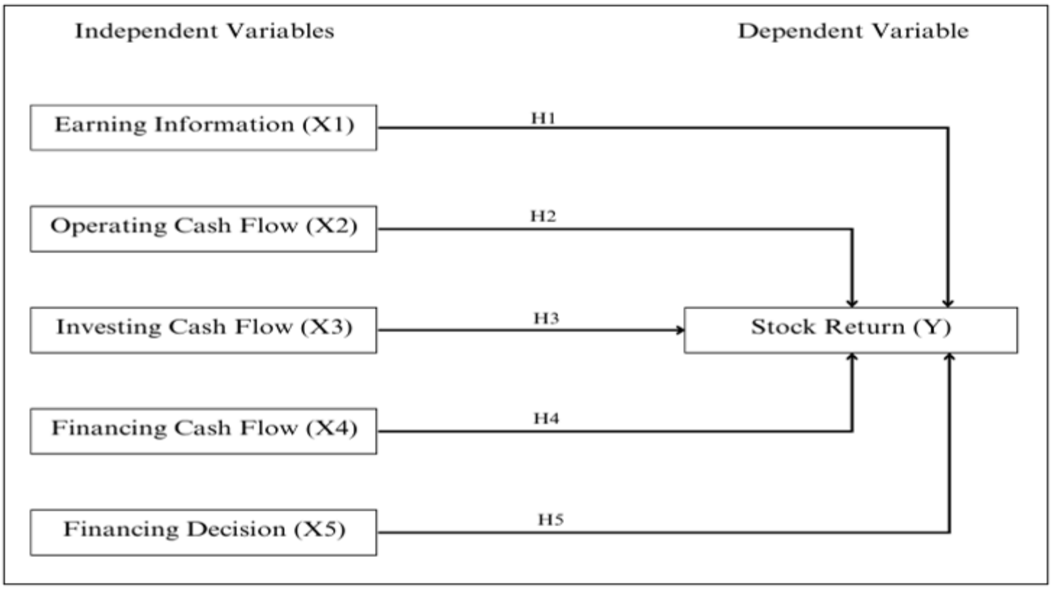
A company's stock return also influenced by its financing decision. Long-term financing instruments such as issuing of shares, bonds, and retained earnings are used to finance the funds required for capital expenditures. Examining the impact of financing decisions on firm value, Suroto (2016) and Jusriani & Rahardjo (2013) show that financing decisions have a positive and considerable impact on firm value. Economic value added (EVA) is a measure of value creation, and Atiyet (2012) examined the effect of debt financing on value creations and found that debt financing considerably and favorably affected EVA. On the other hand, Fenandar and Raharja (2013) demonstrate that financial decisions have little to no impact on the value of a company.

H5: *Financing decisions influences stock returns*.

2.5 Conceptual Framework

The conceptual framework is a useful structure that can explain the expected development of the phenomenon to be investigated. The conceptual framework is reflected according to how the researcher looks at the issue during the investigation. This framework is a way to know the relationship among the variables, the linkages and associations between variables, and how it can be justified logically, specifically, empirically and theoretically (Azam et al., 2021).

Based on the literature review above, this study proposes a conceptual framework as illustrated in Figure 2.1 with five (5) independent variables that consists of earning information, operating cash flow, investing cash flow, financing cash flow and financing decisions and one (1) dependent variable that is stock return.



Source: Data Processed, 2023

Figure 2.1 Conceptual Framework

Figure 2.1 illustrates that earning information, operating cash flow, investing cash flow, financing cash flow, and financing decision has an impact on the stock return.

2.6 Chapter Summary

In conclusion, this chapter contains the explanation of factors that influence stock return, theories that related on stock return and also the gaps that resulted from previous studies. Furthermore, this chapter also presents the conceptual framework for this study and the development of the study's hypotheses.