# CHAPTER I

# INTRODUCTION

## 1.1 Introduction

This research aims to determine the effect of long-term debt and short-term debt on earnings management or profitability on financial performance in manufacturing companies listed on the Indonesian Stock Exchange. This study also examines the size of the board of directors to better understand the board's impact on corporate achievement. Therefore, Chapter 1 begins by explaining the research context, problems and problem formulation, as well as justification for the study. This chapter explains the aims, objectives, research questions, limitations, and importance of research in experimental research. This section concludes with operational definitions of key terminology used throughout the research.

## 1.2 Background of Study

Any firm's capital structure is the essence of maximizing wealth and minimizing the cost of capital (Sheikh and Qureshi, 2017). In indonesia manufacturing sectors, they play long-term financial stability because they are the third-largest economy sector, which contributes about 20% of the gross domestic product (GDP). However, due to the high inflation and interest cost, import-based economy, lower foreign investment and many other economic issues,manufacturing sectors face financial constraints to fulfil their investment needs. Manufacturing firms usually opt for debt financing, which has consequences related explicitly to the firm's profitability. Therefore, it is the most crucial decision for themanagement because, in any corporate firm, it is the management's job to make capital structure decisions that ensure a balanced proportion of both equity and debt. In doing so,policymakers must consider the relevant costs and benefits of these capital instruments (Ahmed Sheikh and Wang, 2011). Capital structure is one of the primary corporate financing decisions because it has a vast influence on company financial performance. These facts encourage and motivate the research to explore the capital-structur decision's insights andits effects on profitability. A number of studies examine the relationship between debt financing and company profitability, with varied and different results. Ezeoha (2008) found that taking on debt had a negative impact on business profitability, confirming the pecking order theory. Companies prefer internal funding sources for fundraising, rather than using external funding (Myers and Majluf, 1984). For companies that are separate entities, both debt securities and shares are forms foreign loans. In the first case, the company owes interest to the debenture holders. In the In the final situation, the company obtains dividends to its shareholders. Directors Companies must decide which source of financing is more cost-effective and take appropriate action.

Margaritis and Psillaki (2010) also found a positive relationship between debt and profitability. In contrast, Weill (2008) argues that debt financing can have a positive or negative impact company performance due to diversified industrial background, prevalent economy situation and other macroeconomic factors. Various studies have found a relationship between financial performance and debt financing (Habib et al., 2016; Margaritis and Psillaki, 2010). Others believe that there is a negative relationship between debt and profits (Habib et al., 2016; Sadiq and Sher, 2016). Several studies, such as Habib et al. (2016) concentrate on non-financial areas company. Economic policies vary from sector to sector with respect to interest rates and tax breaks Indonesia. For example, the Indonesian government decided to lower interest rates for exporters, and the government will pay the difference. This research will add to the current literature on several ways. First, this research focuses on increasing existing empirical knowledge the influence of debt financing on profitability on the main Indonesian Stock Exchange (IDX). sector. Second, this study investigates the debt-performance relationship among these companies manufacturing companies in Indonesia, from the perspective of pecking order theory (Myers and Majluf, 1984), explores whether managers should choose short-term retained earnings long-term debt.

### 1.2.1 Backround of Earning Management Profitability

In the world of business and investment, profitability is an important matrix in assessing company performance. With this financial ratio analysis, it will make it easier for company leaders to assess the company's efficiency in generating profits and sharing them with investors. The greater the company's profitability, the better the performance of the team within it. However, there is a more important thing that needs to be understood in determining profitability, namely how to calculate it. Correct calculations will later have a positive impact on the company itself. Meanwhile, if the calculation is wrong, it could have a negative impact. According to accounting, the profitability ratio is a comparison carried out to find out how much a company's ability to achieve profit or profit from certain income. Profitability is one of the five elements of financial ratios that a company must have. For this reason, let's get to know more about the meaning of profitability here. Profitability is the ability of a company to generate profits during a certain period, measured by comparing profits with the assets or capital that produce these profits. According to Bambang Riyanto (2012).

### 1.2.2 Backround of Company Manufaturing

Manufacturing is a branch of industry that plays a major role in driving the wheels of the economy. The reason is, manufacturing absorbs a lot of labor, thereby helping to raise the level of social welfare. Manufacturing can absorb a lot of labor because companies operating in this field carry out production on a very large scale. According to data from the Central Statistics Agency (BPS), the number of workers in the manufacturing industry in the August 2021 period absorbed up to 18.20 million workers, which is equivalent to 14.3% of the total number of workers in Indonesia. The manufacturing industry is an industrial sector that plays an important role in the economy. The manufacturing industry operates to provide people's needs, such as food, clothing and other necessities. If we refer to the KBBI, the definition of manufacturing is making or producing by hand or machine. It can also be interpreted as the process of changing raw materials into goods that can be used or consumed by humans. We can also divide the definition of manufacturing from two sides, namely the technological and economic sides. From a technological perspective, manufacturing is the application of physical and chemical processes to change the properties, geometry and/or appearance of initial materials into components or products. Manufacturing also covers the field of assembling several components to make a product. In the process, manufacturing involves a combination of machinery, tooling, power/energy, and labor. Meanwhile, from an economic perspective, manufacturing is the process of changing materials into goods of higher economic value through the assembly process. In essence, manufacturing will change the shape or nature of goods or materials by combining them with other materials to increase their economic value. A manufacturing company is a company whose business activities do not purchase finished goods from suppliers. However, they buy raw materials which are then carried out in the production process to create finished goods that are ready to be used. The finished goods which are the result of the company's production are what they will sell to consumers. The profit of a manufacturing company is the difference between sales revenue and costs consisting of cost of goods sold, operational costs, taxes, interest and other costs.

## 1.3 Problem Statement

Long-term debt is debt whose repayment process takes a long time, usually up to 5 to 20 years. Depends on the agreement of the borrower and lender. Usually used by companies that need a large enough budget to develop their business. Short-Term Debt Short-Term Debt is debt that must be repaid or matures within one accounting period. In other words, a debt can be classified as Short Term Debt if it is expected to be paid within 12 (twelve) months after the reporting date.Profitability is a company's ability to generate profits or profits in a certain period, where companies that have the ability to generate good profits can show good company performance. This is because profitability is often used as a measure in assessing a company's performance.

This research will focus on the influence of long-term debt and short-term debt on profitability. by comparing it to the articles that I reviewed as my reference in making this research. Is there a significant difference in long-term debt to profitability and short-term debt to profitability as well as other existing obligations of the manufacturing company.

## 1.4 Research Objective

The general aim of this research is to assess the impact of earnings management on company performance for manufacturing companies listed on the IDX . The specific objectives of this research are:

1. To examine the relationship between long-term debt and profitability

2. To examine the relationship between short-term debt and profitability
3. To identify total debt versus profitability

## 1.5 Research Questions

The research questions are made to help reach the study's main goals and objectives. This study's goal is to answer the following questions about the

What is the relationship between long-term debt and profitability?

What is the relationship between short-term debt and profitability?

What is the relationship between total debt and profitability?

## 1.6 Significance of the Study

This research aims to provide the latest insight into long-term debt and short-term debt that influence relationships between the profitability of a manufacturing company. This research also explores the value of the return on assets (ROA) variable, which if the ROA value is closer to 1, means the company's profitability is getting better because every existing asset can generate profits. In other words, the higher the ROA value, the better the company's financial performance.

## 1.7 Scope Of Study

This research aims to find out how long-term, short-term debt and profitability affect financial performance to assess the company's financial performance. Purposive sampling was used in this research to select a sample of PT companies. Indonesian manufacturing company listed on the Indonesia Stock Exchange and has released financial reports for the 2020-2022 period.

## 1.8 Operational Definition (The Key Terms)

### 1.8.1 Financial Performance

Conceptual definition : Orientation towards profit is also what drives companies to always think aboutstrategies and ways to obtain large profits for the continuity and progress of the company. Therefore, the company must be able to anticipate all risks that occur, the company must master information by using appropriate methods to analyze the situationcompany. However, aspects of company performance are also important apart from profits. Because large profits are not a measure that the company has been able to work effectively. Thus, what the company must do is not just a method or method efforts to increase profits, but what is more important is efforts to increase profits Company performance is the main task of a manager to always maintain stability,growth and achievement of reliable profits with investment, as well as making parties The company is able to implement a strategy so that the company can run effectively and drive the company's progress. The performance of a company is related to howA company manages its resources to produce profitable profits increase company prosperity. Performance is not just a matter of big profits but it is also related to the effectiveness of a company in managing its business. According to Irhan Fahmi (2011) financial performance is an analysis carried out for see the extent to which a company has implemented using the rules implementation of finances properly and correctly. Company performance is a picture of The financial condition of a company is analyzed using financial analysis tools, so that it can known about the good and bad financial condition of a company which reflects its achievements in a certain period. This is very important so that resources are used optimall in facing environmental changes.

### 1.8.2 Debt

Conceptual definition : Debt is the obligation to pay back funds or money to an entity that has debt. This debt is the result of the company's income or capital which originates from creditors. with another view, debt is an obligation that must be paid by the debtor, it can be in the form of exchange or service at a certain time in the future. Or it can be defined as debt, namely collection from debt owners to the company. Loans are divided into two parts: long-term loans are debts whose repayment process takes quite a long time, usually up to 5 to 20 years. Depends on the agreement of the borrower and lender. Usually used by companies that need a large enough budget to develop their business or short-term loans are the company's responsibility to pay back the short term (from the remaining one year) using the company's assets.

### 1.8.3 Profitability

Conceptual definition : In general, every company aims to gain profit or gain. Company management is required to be able to achieve the planned targets. The profitability ratio is a ratio that aims to determine the company's ability to generate profits during a certain period and also provides an overview of the level of management effectiveness in carrying out its operational activities. The effectiveness of management here is seen from the profits generated from sales and company investment. The definition of profitability ratio according to Fahmi (2013) is: "Profitability ratio is to show the company's success in generating profits. Potential investors will carefully analyze a company's performance and its ability to earn profits. The better the profitability ratio, the better it describes the company's ability to generate high profits." Meanwhile, according to Kasmir (2014) the definition of profitability ratio is a ratio to assess a company's ability to make a profit. This ratio also provides a measure of the level of effectiveness of a company's management. This is shown by the profits generated from sales and investment income. Initially, the use of this ratio showed the company's efficiency. Profit in pure economics is defined as an increase in a person's wealth investors as a result of their capital investment, after deducting costs related to the investment. Meanwhile, profit in accounting is defined as the difference between sales price and production costs. Measuring profits is not only important for determining company performance but is also important as information for profit distribution and determining investment policies.

Soemarso (2008) defines that "Profit is the difference between income over costs related to business activities, so the key to the feasibility of obtaining a profit or loss is determining the amount of income generated and the amount of expenses incurred in the period concerned". From the definition and explanation above, profitability has an important meaning in business activities to maintain survival in the long term, because profitability shows that the company has good prospects in the future. Profit is the result of policies taken by management. To measure the level of profit or profitability of a company, financial ratios or profitability ratios are used. The benefits obtained from profitability ratios include knowing the productivity of all company funds used, both loan capital and own capital. In this research, it is described by return on assets (ROA), namely by comparing net profit with the company's total assets. Return on assets (ROA) is an overall measurement of profitability. The formula for calculating profitability using return on assets is:

$$\text{ROA ( Return On Asset )} = \frac{\text{Earning After Interest in Tax}}{\text{Total Asset}} \times 100\%$$

### 1.2.1 Summary of the Chapter

In this part, the subject of the study is explained. Starting with the background of the study, the problem statement, research questions and goals, the significant of the study, its scope, and its limits. The operational definitions for the variables examined in this study were created.