CHAPTER II
LITERATURE REVIEW

2.1 Introduction

This chapter aims to review previous studies on the concept of earnings management and board size's impact on the performance of the manufacturing companies listed on the Indonesian Stock Exchange. Also enfolded is the theoretical groundwork of this study, with the variables and the performance.

2.2 Pecking Order Theory as an Underpinning Theory

Pecking order theory in capital structure analysis is developed by Myers and Majluf (1984). Based on this theory, the company's main source of capital the first time it must come from the company's business results in the form of net profits after tax which is not distributed to the parties company owner or shareholder (profit detained). These retained earnings will be invested back in the company's business or project profitable. If retained earnings are not enough to finance the investment project profitable, then the company can increase his capital by searching funds from debt and then from capital own or equity (Myers and Majluf, 1984). This order of capital structure explains why the pecking order theory appears to be wrong one capital structure theory that explains how the company finances its activities. Capital structure theory explains balance between long-term debt and own capital (equity). Capital structure theory irrelevant in terms of value the company had been proposed by Modigliani and Miller (1958). If debt can increase company value (Modigliani and Miller, 1963) due to savings in the tax model, then the company must consider trade off between costs incurred due to financial difficulties (financial distress), costs agency (Jensen and Meckling, 1976) and benefits taxes, so that a debt ratio is achieved optimal. However, the pecking order theory states that there is a target debt ratio the company wants to achieve value particular company (Frank and Goyal, 2005). The pecking order model argues that this theory emerged because of asymmetry information between the company and its investors. Therefore, a hierarchy of company financing emerged that started with profit withheld which has costs of information asymmetry lowest, followed by debt, and finally equity or own capital from external sources which has the highest information asymmetry costs

(Cohen, 2003). Therefore, Indonesia with relatively developed capital markets would be a good place to test Empirically, the pecking order theory is related with company performance assessments. One of the important factors in make financing decisions is the relationship between real capital structure company and optimal capital structure (Brigham and Ehrhardt, 2005). It's been explained previously that capital structure is combined long-term financing consists of long-term debt and capital itself which consists of special shares and common stock. Capital structure has an important influence on profits and company stability. Proportion of debt larger

can increase growth high profits, but on the other hand large debt will increase the possibility of bankruptcy for the company, especially if the debt causes the company's growth is small oreven negative (Frank and Goyal, 2009). This research uses pecking order theory as the underlying theory because it helps understand further the relationship between IV and DV in this research.

2.3 Reseach Framework and Hypothesis Development

2.2.1 The relationship between long-term debt and profitability

The long-term debt to profitability ratio is a financial metric that measures a company's profitability in relation to its long-term debt. This is used to assess a company's ability to pay its long-term debt and the potential risks associated with its debt burden. This ratio is important for investors and creditors, because it provides insight into the company's financial health and risk profile.The formula for calculating the long-term debt to profitability ratio is as follows:

Long Term Debt to Profitability Ratio = Long Term Debt / ProfitabilityWhere:

Long-Term Debt is the total amount of debt a company has with a maturity period of more than one year. This usually includes items such as bonds, loans, and other long-term liabilities. Profitability can be measured in various ways, but common metrics used in this context include net profit, EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), or operating income.

A lower long-term debt to profitability ratio is generally viewed as more favorable, as it indicates that the company's profitability is sufficient to cover its long-term debt obligations. Conversely, a higher ratio indicates that the company is at greater r isk of financial distress, because its debt level is relatively high compared to its profitability. Some considerations when interpreting the long-term debt to profitability ratio:

Risk Assessment: Lenders and investors use this ratio to evaluate the risks associated with a company's debt. A lower ratio indicates lower risk, while a higher ratio indicates higher risk. Industry Comparison: It is important to compare ratios with industry benchmarks and similar companies. Industries with different capital structures and risk profiles may have acceptable ranges for this ratio. Trends: Analyzing changes in ratios over time can provide insight into a company's financial health. The worsening trend may be a cause for concern. Debt Repayment Ability: This ratio does not consider other financial commitments, such as interest expenses. It is important to assess the company's ability to fulfill all its debt payment obligations. Profitability Measures: The choice of profitability measures can affect the ratio. Different measurements can provide varying results, so it is important to be consistent in your analysis. In short, the long-term debt to profitability ratio is a useful financial metric for assessing a company's ability to meet its long-term debt obligations compared to its profitability. This should be considered in the context of a company's industry, financial trends, and other financial metrics for a more comprehensive assessment of its financial health and risks.

2.2.2 The relationship between short-term debt and profitability

The short-term debt to profitability ratio is not a commonly used financial ratio, and is not a standard measure of a company's financial performance or health. However, this can be interpreted in several ways, depending on how you define “short-term debt” and “profitability”. What is meant by "short-term debt" is the company's current or short-term liabilities (for example trade debt, short-term loans, current portion of long-term debt) and what is meant by "profitability" is the company's debt. profit margin or return on investment metric, you can calculate a ratio that reflects a company's ability to cover its short-term liabilities with its profitability. This ratio might look like this:

Short Term Debt to Profitability Ratio = (Short Term Debt) / (Profitability Metric)

For example, you might use a company's operating profit or net profit as a profitability metric. A higher ratio in this context could indicate that the company may have more short-term debt relative to its profitability, which could be a sign of financial stress or liquidity problems.

On the other hand, if you want to assess a company's ability to generate profits relative to its short-term debt, you can invert the ratio:

Profitability to Short Term Debt Ratio = Profitability Metric/ Short Term Debt

In this case, a higher ratio indicates that the company is generating more profits relative to its short-term debt, which can be seen as a positive indicator of financial health. However, it is important to note that using these ratios separately may not provide a complete picture of a company's financial condition or profitability. Financial analysis typically involves considering various financial ratios and other factors to assess a company's overall health, stability, and performance. Financial ratios commonly used to evaluate a company's financial health include the current ratio (current assets divided by current liabilities), quick ratio (quick assets divided by current liabilities), debt-to-equity ratio, and various profitability ratios such as return on assets. (ROA) and return on equity (ROE). It is important to consider the specific financial circumstances and industry benchmarks when analyzing a company's financial position. Always consult with financial experts and consider a comprehensive set of financial metrics when making financial assessments or investment decisions.

2.2.3 The relationship between total debt and profitability

The relationship between total debt and profitability is a crucial aspect of financial management and analysis for businesses. Liquidity and profitability are two distinct but interconnected financial metrics that provide insights into a company's financial health and performance. Let's explore the relationship between these two concepts:

Total debt

Total debt, or total liabilities, is the total amount of financial obligations that a company has to other parties at any given time. It includes all types of debts owed by the company, both short-term and long-term. Total debt is often used as an indicator of a company's financial health and its ability to meet its financial obligations. Total debt is an important measure in financial analysis that includes all of a company's financial obligations. Understanding total debt and its components helps management, investors, and creditors assess a company's financial health and ability to meet financial obligations.

Profitability

Profitability measures a company's ability to generate earnings in relation to its revenue, assets, or equity. Key profitability ratios include net profit margin, return on assets (ROA), and return on equity (ROE). These metrics provide insight into how effectively a company is generating profits from its operations and investments.High profitability suggests that a company is effectively managing its costs and generating substantial earnings. Conversely, low profitability may indicate inefficiencies in operations or a lack of competitive advantage**.** The relationship between total debt and profitability is complex and contextual. The use of debt can increase profitability through tax benefits and management discipline, but it can also reduce profitability if interest costs and bankruptcy risk are too high. Firm management must consider various factors, including market conditions, industry structure, and firm-specific characteristics, to achieve an optimal capital structure and maintain a balance between risk and return. Empirical research shows that this relationship is not linear and depends on many internal and external variables.

Previous research results show that short-term and long-term debt have a negative and significant impact company performance in profitability. This shows that agency problems can lead to high debt policies, resulting in lower performance. However, both sales growth and company size have a positive influence on non-financial profitability sector companies (Aamir, Muhammad,Muhammed, 2019). Previous research results (Asif and Hadeeqa, 2018) show that there is a positive relationship between liquidity and profitability negative relationship between financial leverage and profitability. Results to measure CR liquidity reveals a strong positive impact on ROA and the DE ratio financial leverage measure shows a negative one the impact is not strong on ROA. Another part of the results concludes that there is a strong positive impact of CR ROE also and DE have a negative impact on ROE.

This research develops three hypotheses that are in line with what will be researched. The hypothesis below is formulated with the view that manufacturing company profitability management and the size of the company's board of directors indicate better company performance so that it can satisfy investors and the market, which has an impact on increasing performance and market prices.

H1: There is a significant relationship between Long Term Debt and Profitability.

H2: There is a relationship between Short Term Debt and Profitability.

H3: There is a relationship between total debt and profitability

These framework concepts are related to each other, including long-term debt to profitability, short-term debt to profitability and liquidity to profitability.

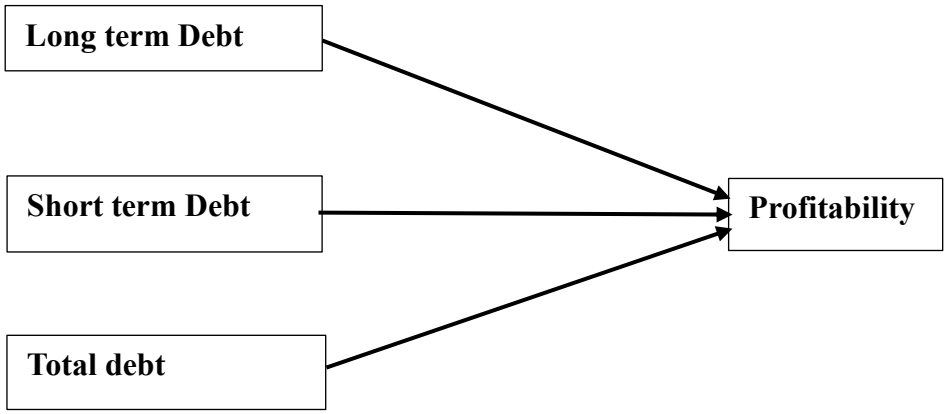

Figure 2.3.1 : Conceptual Framework of the relationship between Debt on Profability