CHAPTER I

INTRODUCTION

1.1 Background of Problem

Go-Public company is accostumed to be society's possession and is demanded to preserve public reliance. One of the preserve action is providing actual information for investors. The information could refer to incidentil reporting and periodic reporting such as audited financial-reporting. According to capital market laws Number 8 year 1995 par. 86 obligate company to report to Bapepam and society about material events that could influence stock performance no longer than the end of 2nd day after the events. The information is required for investors to analyze risk rate and predict balanced return from their investment.

According to IFRS (2010:1) the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decision about providing resources to the entity. Moreover, it is directed at users who provide resources to a reporting entity, but lack the ability to compel the entity to provide them with the information they need to make decisions about their investment. In order to provide this, financial statements should live up basic characteristics. One of the basic qualitative characteristics of financial statements is relevant. According to IFRS (2010:2), the relevant accounting information could influence economic decision of the financial reporting users by assisting

them to evaluate past, present, and future events, and also determining or correcting the evaluation of the past.

Francis and Schipper (1999) explain the value-relevance of financial reporting could be measured by the ability of the financial reporting to seize and comprehend any accounting information that impact the stock return. Value relevance is also defined as the ability of accounting numbers contained in the financial statement to explain the stock market performance (Beisland, 2009). Hence, the accounting information is supposed to be assistance for investors on decision-making. However, Francis and Schipper (1999) reported the relevance of financial statement toward investors' decision-making has declined since the decline of value relevance. Lev and Zarowin (1999) also found that the value relevance of reported earnings and book equity have deteriorated over the past 20 years. In Indonesia, Pinasti (2004) also found the decline of value relevance of accounting information on 1990-2001. Sari (2004) also conducted research that examined the value relevance of earnings on the before and after crisis period (1995-1998) and found the value relevance of earnings has declined on the period.

Earnings is one of the accounting information which have drew investors' investment decision. The stock price of the three live-stock food, PT Charoen Pokphan Indonesia Tbk (CPIN), PT Japfa Comfeed Indonesia Tbk (JPFA), and PT Malindo Feedmill Tbk (MAIN), have been decreased since the sales of the companies have declined for the three kuartal of 2014 (Katadata.co.id). Investors react to earnings since it is the indicator to evaluate the past and predict the future performance of companies (Kieso, et al 2007). However, earnings reporting that

influence investors' decision is related to the persistance of earnings. Earnings might contain transitory and permanent income and there is no acceptable method has been developed to decomposing the two components of earnings. However, Ali and Zarrowin (1992) have conducted research toward return-earnings relation and they found the transitory items could lead the bias estimation on return-earnings relationship and it is also supported by Cain et al (2014). Rahmawati (2005) and Djadmiko (2008) also found that transitory items on earnings might be less relevant or interfere the return-earnings relationship.

Book value is also one of the accounting information that has been taking a part on capital market-based accounting research. Barth et al (1998) found book value relatively becomes more important explanatory variable for stock returns than earnings when firm's financial health is deteriorates. However, the restrictiveness of book value is about the errors on measurement and judgements (Kieso, et al 2007). Some empirical studies on book value items compare the historical cost and fair value estimations. Historical cost is labelled as more reliable but fair value is taking the part of relevance. When we focus on value relevance, we presumed that fair value is better estimation than historical cost. However, when there are crisis or the imperfect market, fair value might be less relevant and lead to occurance of misinterpretation of book value items (Bignon, et al 2009).

Debt is one component of financial item that might take investors' interest. Debt is one of the capital-structure's option that being prioritized by both internal and external users. Investors prefer debt financing than stock issue because of the

tax benefit. The trade-off theory by Modigliani and Miller (1958) mentions about the balance of cost and benefit of debt. The debt could boost up company's performance since it could support the shortage of financing for operational activities. Boosting up perfomance is the sign for the promising return in the future. However, the interest rate of debt and the bankruptcy possibly occur when the cost has taken over the benefit of debt financing. Hence, the rate of return possibly decrease.

Therefore, the fact about value relevance of accounting informations have been declined for years, then the urgent of discovering the cause and solution is emerging. Since the value relevance of earnings, book value, and debt have dynamics on their own -the transitory items on earnings, the debate beetween the fair value and historical cost measurement of book value items, and the trade-off theory of debt- blend on the value relevance of the three accounting informations, then the non-linear model is presumed to make them more relevant for investors' decision-making since the business environment in the real world, however, is not certain. Non-linear model is the function that relating the dependent variable with the independent variable which is not contant with the alteration of the independent variable. (Suharyadi and Purwanto 2009:252).

The research will be conducted with few differences with the previous research conducting by Djadmiko (2008). This research adds debt as additional variable and exclude the size as variable. The research focuses on manufacturing company that listed in BEI on 2014.

Therefore, the title of the research is **"Value Relevance of Earnings, Book Value, and Debt toward Stock Performance: Non-Linear relationship (Study at Manufacturing Companies listed in BEI on 2014)"**

1.2 Identifications of Problems

1. Have the value relevance of accounting informations also declined for the past decade?

2. Is there any earnings valuation for decomposing the transitory and permanent items on earnings?

3. Is fair value being more relevant than historical cost?

4. How is debt able to either boost up and decrease the rate of return?

5. Could non-linear model represent the value relevance of accounting information to be more relevant?

6. Why does manufacturing industries is used as the population of value relevance research?

1.3 Limitation of Problem

Since the non-linear model is presumed to make the accounting information being more relevant for investors, than the valuation of decomposing earnings items, the comparison of book-value's measurement and method of cost and benefit of debt would not be examined seperately.

In addition, Biddle et al (1991) found that return-earnings relationship differs across industries and Alali and Foote (2008) also found that return-earnings is varied by years and industry, then the research would focus on one industry and one year. Manufacturing is selected because the previous research

had conducted reasearch on banking industry with the reason for banking industry to be more regulated than other industries. Also, manufacturing industry has more judgment on considering certain factors of additional financing source.

1.4 Research Questions

1. Do earnings have value relevance towards stock performance with non-linear relationship?

2. Does book value have value relevance towards stock performance with non-linear relationship?

3. Does debt have value relevance towards stock performance with non-linear relationship?

1.5 Objectives of Research

1. The research is conducted to examine the value relevance of earnings towards stock performance with non-linear relationship

2. The research is conducted to examine the value relevance of book value towards stock performance with non-linear relationship

3. The research is conducted to examine the value relevance of debt towards stock performance with non-linear relationship

1.6 Benefit of Research

1. For the academician, as the training to participate into accounting research area and also increase the knowledge of value relevance of accounting information

2. For UNIMED, as the addition research of the accounting area especially the relevance of accounting information

3. For the object, as the revaluation of the related standards of accounting information that could increase its value and assist the related user