# CHAPTER 2

# LITERATURE REVIEW

## 1.1 Signaling theory

According to Brigham (2011) Signaling Theory is an action taken by company management that gives investors clues about how management views the prospects of a company. Companies with lucrative prospects will try to avoid the sale of shares and exploit any new capital required in other ways, including the use of debt.

Signaling theory argues about how a company should signal to users of financial statements. This signal is information about what has done by the management to realize the desire of the owner. Signals can be promotional or other information that states that the company is better than other companies. Signal theory explains that signals done by managers to reduce information asymmetry. Managers provide information through financial statements they are implementing a conservative accounting policy that results in higher profits because this principle prevents firms from enlarging profits and helping users with financial reports by presenting quality profits and assets.

## 2.2 Agency Theory

Agency theory developed by Jensen, M. C, and W. H. Meckling (1976). According to Brigham (2011), agency theory is the theoretical basis underlying the company's business practices over the years. Theory to the agent is root in the synergy of economic theory, decision theory, sociology, and organizational theory. The main principle of this theory state existence of working relationship between the parties who allows the investor with the party who receives the authority (Agency) is manager. Separate owners and management in the accounting literature called Agency Theory (agency theory). This theory is one theory that emerged in the accounting development research which is a modification the development of financial accounting model by adding aspects of human behavior in the economic model.

In agency theory, agency relationships arise when one person or more (principal) uses another person to provide a service and then delegates decision-making authority to the agent the relationship between principal and agent can lead to an asymmetric information (asymmetric information) because the agent is in a position that has more information about the company than the principal with the summation that individuals act to maximize their own self-interest, it will encourage the agent to hide information that the principal does not know. Asymmetry, agents can influence the accounting figures presented in the financial statements by means of earnings management.

## 2.3 Company Value

The company value is the value of the market price of shares of the company between buyers and sellers when transactions occur, because the value of the company's stock market price as a reflection of the real assets of the company (Wahyudi and Hartini in Sadiani and Darmayanti, 2016).

The company value can also be defined as the views of investors about the company's level of success that is often associated with the company's stock price (Sudjoko and Soebiantoro 2007 in Hardiyanti, 2012). With the company's higher stock price will increase the value of the company and will also provide good prospects for investors towards future growth of the company. When investors already have good prospects for the company, then investors will replant their capital in the form of contained earnings in the company in the hoping to gain profit, so the company 11 has a set of investment opportunities and can conduct investment activities to increase the value of the company.

## 2.4 Leverage

Funding policy is a policy that discusses the costs to be borne by the company because the company uses the funds derived from the loan (Husnan, 1998 in Goddess, 2010).

Leverage is a description of a company in financing its assets using debt compared to using its own capital (Weston and Copeland, 1992 in Hidayanti, 2012). By using leverage the company can not only gain profits, but also can make the company get a loss, because the financial leverage means the company will incur risks to the shareholders so that will affect the stock return. Sources of funds that can finance the company's assets (Brigham and Houston, 2000 in Son, 2016) include:

### 2.4.1 Fund Source according to its origin

#### 2.4.1.1 Source of internal funds

Funds originating from internal sources represent funds or capital formed or self-generated within the company, such as contained earnings and depreciation. The amount of profits kept by the company is influence by the amount of profit got by the company over a certain period and the dividend policy made by the company, while the amount of depreciation of the company determined depreciation methods undertaken by the company.

#### 2.4.1.2 Source of external funds

External sources of funds are sources of funds that come from outside the company. The sources of funds from outside the company may come from creditors and owners, participants or shareholders of the company. Funds originating from the creditors are funds in the form of debt to companies and capital derived from creditors called foreign capital, while the funds from the owners, participants or owners part of company is a fund that will continue to be embedded in the company and will become its own capital. Thus external funds comprise foreign capital and own capital.

### 2.4.2 Fund Source According To the Term Time

#### 2.4.2.1 Source of short term funds

The short-term funding source is a source of funds embedded within the company for approximately one year planted by the company, there are several types of available funding sources such as accounts payable, bank debt and 13 even accrual accounts (transactions not yet recorded in the account).

#### 2.4.2.2 Long-term funding sources

Long-term funding sources are a source of funds embedded within the company for more than 10 years. There are several types of sources of funds available to companies such as long term debt, preferred stock, and common stock.

## 2.5 Profitability

Profitability is one measure for the performance of a company, the profitability of a company shows the ability of a company in generating profit during certain period at a certain level of sales, assets and capital stock. Profitability of a company can assess in various ways depending on the profits and assets or capital to be compared with each other. Return on equity or profitability is a measurement of the income or income available to the owner of the company for the capital they invest in the company.

According to Harahap (2009: 304) profitability ratio or profitability also describes the ability of companies to earn profits through all the ability, and existing sources such as sales activities, cash, capital, the number of employees, the number of branches, and so on. Ratio describes the ability of companies generate profit also called operating ratio.

Profitability is one of the company's performance measurements that show the company's ability to generate profit during certain period at certain level of sale, asset, and share capital (Yudiana and Yadnyana, 2016).

According to Kashmir (2013: 196) said “Profitability ratio is the ratio to assess the ability of companies in the search for profit". The types of profitability ratios that can be used (Cashmere, 2013: 199-207), are:

1. Profit margin on sales

Profit Margin Ratio is one of the ratios used to measure profit margins on sales.

2. Return on Investment (ROI)

Return on Investment is a ratio that shows the return (return) on the amount of assets used in the company. ROI is also a measure of management effectiveness in managing its investments.

3. Return On Equity (ROE)

Return on Equity (ROE) is the ratio to measure net income after tax with own capital. This ratio shows the efficiency of this own capital use. The higher this ratio is better to the company (Helmy Fahrizal, 2013). It means that the position of the company owner is stronger, and vice versa.

4. Earnings Per Share

The ratio of earnings per share or also called the ratio of book value is the ratio to measure the success of management in achieving profit for shareholders.

According to Cashmere (2013: 204) Return on Equity (ROE) is a ratio to measure net income after tax with own capital. This ratio shows the efficiency of this own capital use. The higher this ratio is the better to the company. It means that the position of the company owner is getting stronger and the company vice versa.

According to Hanafi and Halim (2012: 82) Return on Equity (ROE), this ratio measures the ability of a company to generate profits based on certain share capital. This ratio is a measure of profitability from the point of view of shareholders. The formula for finding Return on Equity (ROE) can be used as follows:

$$Return\ on\ Equity = \frac{Net\ Profit}{Equity}$$

From the above understanding of the variables used to represent profitability is Return on Equity (ROE). Return on Equity (ROE) provides an indication of how well a company will use investors' investment money to generate profits so as to maximize value on the company.

## 2.6 Dividend Policy

Understanding dividend policy according to Agus Sartono states that: "The dividend policy is a decision whether the profits earned by the company will distribute to shareholders as dividends or will be kept in the form of contained earnings to finance future investment".

Dividend policy is a policy to share the profit to shareholders to distribute in the form of dividends and the amount of contained earnings for the needs of business development (Gitosudarmo and Basri, 2008). Dividend policy should be plan for the two basic objectives with due regard to maximizing shareholder wealth and sufficient financing. The two objectives are interconnected and must satisfy various legal, contractual, internal growth, owner-related and market-linking factors that limit policy alternatives.

While the definition of dividend policy according to Suad Husnan and Enny Pudjiastuti states that: "Dividend policy is a policy that concerns the use of profits into the rights of shareholders, the profit can be divided as dividends or arrested for reinvestment,".

Contained earnings are thus one of the most important sources of funds to finance corporate growth while dividends are cash flows paid to shareholders or "equity investors".

If the company distributes profits as dividends, it will reduce the contained earnings and reduce the total internal or internal financing sources. if the company holds the profit earned, then the ability of the formation of internal funds will be greater.

In the financial world, there are basically three concepts of dividend policy: **irrelevance theory, bird in the hand theory, and residual theory of dividends.**

### 2.6.1 Irrelevance Theory

Irrelevance theory is a theory that states dividend policy has no influence both on the value of the company and the cost of capital. According to this theory, dividend policy does not affect stock prices or cost of capital. Therefore, dividend policy becomes irrelevant. This theory was developed by Miller and Modigliani (1961), which states company value, is determined by expected earnings and corporate risk. The value of a company depends only on the expected profits of the asset, not from separate profits into dividends and kept earnings. This theory assumes that dividend policy has no impact on the value of the firm. Thus, the increase or decrease of dividends by the company will not affect the value of the company.

### 2.6.2 Bird in the Hand Theory

Theories developed by Lintner (1962), Gordon (1963), and Bhattacharya (1979) explain that investors favor high dividend income because dividend income is received as a bird in the hand with a higher value and risk small than the capital in the bush because dividends are more certain than capital income. This theory also argues that investors like dividends because cash in hand is more valuable than wealth in other forms. The company's stock price will be determined by the amount of dividends distributed. Increased dividends will increase the share price that will also affect the value of the company.

### 2.6.3 Residual Theory of Dividends

According to the theory of residual dividends, firms set dividend policy after all profitable investments are financed. The paid dividend is a residual after all the profitable investment proposals have been finance.

### 2.6.4 Aspects of Dividend Policy

#### 2.6.4.1 Stock Dividend

With the conduct of a stock dividend, no cash outflows are making, but only a book-keeping transactions to move a certain amount of money from the estimate of the contained earnings to the estimated paid-up capital stock. Stock dividend is additional share payment to shareholders, and shows the company's capital rearrangement, while the proportion of shareholder holdings remains unchanged.

#### 2.6.4.2 Stock Split

Stock splits of the nominal value of the stock into a smaller nominal value. Splitting these old stocks into new shares will cause the number of outstanding shares to increase. The purpose of stock split is to place the stock market price in a certain trading range.

#### 2.6.4.3 Repurchase of Stock

As an alternative to giving dividends in the form of cash, the company can distribute revenues to shareholders by repurchasing the company's shares (repurchasing stock). The repurchased shares will be booked as an estimate of Treasury Stock. By buying back some shares, the number of shares in circulation will decrease, if it is assumed that the repurchase of shares does not affect the profit of the company, the EPS will increase, which will increase the stock market price. The increase in stock market prices will provide capital gains for dividends to its shareholders.

## 2.7 Investment Opportunity

The term Investment Opportunity Set (IOS) emerged after Myers (1977) views the value of the firm as a combined asset in place with future investment options. Investment choice is an opportunity to develop, but often companies can not always carry out all investment opportunities. For companies that can not use investment opportunities will experience higher expenditure compared to the value of lost opportunities. Investment opportunity set (IOS) is a component of corporate value and results from options for making future investment decisions (Natalia, 2013).

Differences from the results of previous studies can be solve through a contingency approach, is by adding other variables that may affect the capital structure and dividend policy with firm value. The moderating variable used, is Investment Opportunity Set (IOS) in testing the effect of firm value. Investment opportunities owned by the company can affect the value of the company by using the market value indicator of the stock.

Research on the influence of IOS on corporate value has been practiced. Astriani (2014) and Pratiska (2012) prove IOS positively influences the value of the company. Investment Opportunity Set (IOS) describes the investment opportunity or the extent of opportunity for the company Hartono, (2003: 58) in Ahmad, (2009) based on the above definition that the investment option is an opportunity to develop, but some companies cannot implement all investment opportunities, for a company that cannot use the investment opportunity it will experience a higher expenditure compared to the value of lost opportunities. Investment opportunity can be measure by the increase in net fixed assets. This is under the statement of cash flow format that measures the investment of long-term investments and tangible fixed assets.

### 2.7.1 Theory of Capital Structure

Theory of capital structure aims to provide a basic thinking to know the optimal capital structure. Researchers use several theories of Modigliani and Miller approach theory, agency theory, trade off theory and Pecking Order Theory.

### 2.7.2 Modigliani and Miller Approach

This theory was proposed by Franco Modigliani and MH. Miller (MM) opposes the traditional approach by offering a constant justification for the behavior of the company's capitalization rate. MM argues that the total risk for all shareholders is unchanged even though the company's capital structure changes (Martono and Agus, 2005). This is base on the opinion that the division of the capital structure between debt and equity is always there to protect the value of investment. That is because the total investment value of the company depends on profit and risk so that the value of the company does not change although its capital structure changes.

### 2.7.3 Agency Theory

This theory was proposed by Michael C. Jensen and William H. Meckling in 1976 (Horne and Wachowicz, 1998), management is an agent of shareholders, as the owners of the company's shareholders expect agents to act on their behalf to delegate authority to agents. To perform its functions, management should be give adequate incentives and supervision.

### 2.7.4 Trade of Theory

This theory refers to a thought companies should choose how much funding comes from debt and how much of that equity will balance the cost benefits of both. An important goal of this theorem is to clarify a fact that companies are financed from debt and from equity.

### 2.7.5 Pecking Order Theory

This theory refers to a thought companies should choose how much funding comes from debt and how much of that equity will balance the cost benefits of both. An important goal of this theorem is to clarify a fact that companies are financed from debt and from equity.

Pecking order theory explains the funding sequences. The financial manager does not take into account the optimal level of debt. Funding needs are determine by investment needs. Pecking order theory explains why firms with high profitability have small debt levels. Companies will consider factors in capital structure decisions. Factors influencing capital structure decision in a pecking order theory perspective are profitability, firm size and business risk (Cahyani, 2013).

## 2.8 Previous research

**Table 2.1 Previous Researches**

| Author and Year of Publication | Research Title | Research Result |
|---|---|---|
| **Agustin Pramudyastuti (2017)** | **THE INFLUENCE OF LEVERAGE, DIVIDEND POLICY AND PROFITABILITY OF FIRM VALUE WITH INVESTMEN OPPORTUNITY SET AS AN INTERVENING VARIABLE (Study On Manufacturing Company Listed on Bei Year 2010-2014)** | Based on the results of data analysis, the conclusions obtained in this study are 1). Leverage has positive effect to set of investment opportunity and company value, 2). The policy of dividend negatively affects investment opportunity sets and positively affects the firm's value. 3). Profitability positively affects investment |

| | | |
|---|---|---|
| | | opportunity sets and corporate value. 4). Investment opportunities have a positive effect on firm value. |
| **BayuIrfandi Wijaya[1,]<br>I.B. PanjiSedana[2]<br>(2015)** | **THE EFFECT OF PROFITABILITY TO THE VALUE OF THE COMPANY (DIVIDEND POLICY AND INVESTMENT OPPORTUNITY AS MEDIATION VARIABLES)** | 1. Profitability has a significant positive effect on dividend policy.<br>2. Profitability has a significant positive effect on investment opportunities.<br>3. Profitability has a significant positive effect on firm value.<br>4. Dividend policy has a positive effect on firm value.<br>5. Investment opportunity has a significant positive effect on company value.<br>6. The dividend policy strengthens the effect of profitability on firm value.<br>7. Investment opportunity strengthens the effect of profitability on firm value. |
| **MaretaNurjinSambora, SitiRagilHandayani, SriMangestiRahayu<br>(2014)** | **EFFECT OF LEVERAGE AND PROFITABILITY ON THE VALUE OF THE COMPANY (Studipada Food and Beverages Company listed on BEI period of 2009 - 2012)** | 1.DER, EPS, ROE, and DR variables are simultaneously significant effect on the price of the company's food and beverages for the period of 2009-2012.<br>2.DER variable partially insignificant effect on stock |

| | | |
|---|---|---|
| | | price with sig value.<br>3. Independent variables that have dominant influence to stock price in this research is EPS. |

## 2.9 Framework

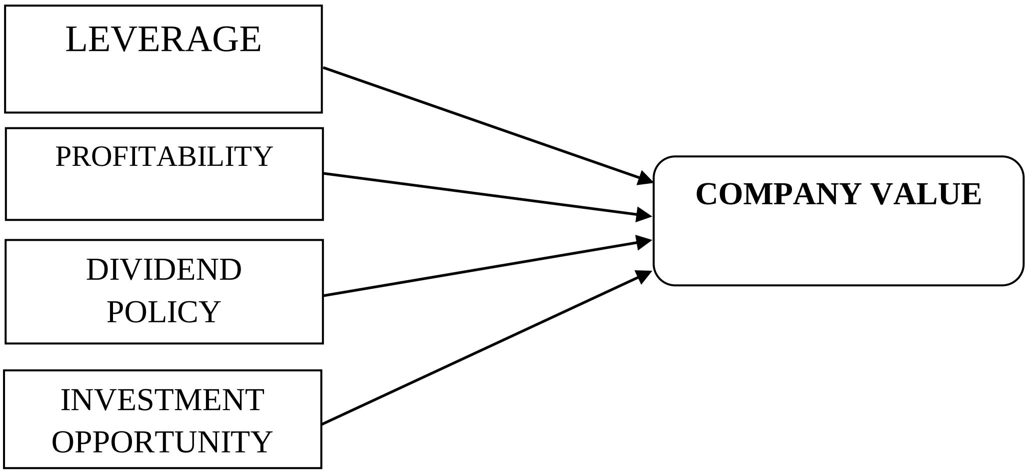


**Figure 2.1 Framework Research**

Figure 2.1 shows the research framework used in this study. Basic theory of variables in this study is a group of independent variables and dependent variable. This framework is show the influence of independent variables on the dependent variable. The independent variables in this study are leverage, profitability, dividend policy and investment opportunity. The dependent variable in this study is company value.

## 2.10 Hypothesis

### 2.10.1 Effect of leverage on the company value

Debt (leverage) is one tool that companies used to increase their capital to increase profits (Singapurwoko, 2011). This debt can come from banks or other financing. Companies that do too much financing with debt, considered unhealthy because it can reduce profits. Excess large debt will have a negative impact on corporate value (Ogolmagai, 2013) while research Yuyetta (2009) states that leverage does not affect the value of the company. The research conducted by Fama (1978) supported by Cortez & Stevie (2012), Akinlo & Asaolu (2012), stated that the value of debt had a significant negative effect on firm value, and Mahendra research, et al. (2012) states that leverage has a negative effect is not significant to the value of the company.

**$H_1$ : Leverage has a negative significant impact on company value.**

### 2.10.2 Effect of profitability on company value

According to Rizqia, et al. (2013) companies that can maintain stability and increase earnings can be seen as a positive signal by investors related to company performance. This happens because companies experiencing profits increase reflects that the company has a good performance, thus raising positive sentiment from investors and can make the company's stock price increased. Rising stock prices in the market means that the value of the company also increases in the eyes of investors. The results of research conducted by Mardiyati (2012), Setiabudi and Dian (2012), Rizqia et al., (2013) show that profitability positively influences firm value.

**$H_2$ : Profitability has a positive and significant effect on company value.**

### 2.10.3 Effect of dividend policy on company value

The dividend policy relates to the company's policy of how much dividend should be distribute to shareholders and the resulting profits. The amount of dividend distributed will affect the stock price of a company. Companies that provide dividends and increase will provide a positive sentiment to investors. The results of research conducted by Dasilas et al. (2009), Son et al. (2010), Afzal and Abdul (2012), and Mardiyati (2012) show that dividend policy influences firm value.

**$H_3$ : The dividend policy has a positive and significant impact on the Company value.**

### 2.10.4 Effect of investment opportunities on company value

Companies with high investment opportunities are companies with bright prospects and will influence the company's stock price (Rizqia et al., 2013). Investment opportunities show the ability of firms to profit from growth prospects. The prospect of a company is an expectation desired by management and investors and creditors. Thus investment opportunities have a positive influence on firm value. Research conducted by Andriyani (2011), Rakhimsyah and Barbara (2011), and Rizqia et al. (2013) get evidence that investment opportunities have a significant positive effect on firm value.

**$H_4$ : Investment opportunities have a positive and significant impact on the value of the company.**