

CHAPTER II

REVIEW OF RELATED LITERATURE

2.1. DEFINITION OF FINANCIAL STATEMENT

A party that wants to know the growing of one company really needs financial statement to predict the financial performance from that company. The analysis of balance sheet will result in the whole picture of financial position from one company and the analysis of income statement will give information about the growth of one company.

There are some definitions about financial statement, such as:

1. Definition of Financial Statement according to Bambang Riyanto:

“Conclusion of financial condition from one company, where the balance sheet reflecting assets; liabilities; and stockholders equity, and income statement that reflecting the result that achieved in one period” (Riyanto, 1977: 261).

2. Definition of Financial Statement according to Myer in his book of *Financial Statement Analysis*:

“Two lists that are made by accountant at the end of period for one company. These two lists are list of balance sheet and list of income statement” (Munawir, 1988: 5).

The financial statement in one company is really important for themselves or another party that has interest to that company. It happens because financial statement can give quantitative financial information from one company to fulfill the needs of financial statement user to measure financial performance of that company.

2.2. THE IMPORTANCE OF FINANCIAL STATEMENT

In one organization, especially for a company, financial statement is as a basis to determine or to measure the financial position and the result from one company. Financial statement also can be used as a communication tool between financial data and those that need financial data. From a financial statement, the user can make a decision for company's future. There are some parties that are interested to the financial statement, such as:

1. The Owner

The owner really interested to the company's financial statement, because with the financial statement, the owner can measure the results that are achieved in the past and to predict the profit that will be achieved.

2. Financial Manager

Financial statement is a tool for financial manager to report their responsibility to the owner.

3. Investors, Bankers, and Creditor

They need to know the profitability prospect in the future and to see the companies growing, to know their investment's guarantee and to know short-term financial condition. So, they can determine their next step in the future.

4. Government

Financial statement is useful for government to determine the amount of tax for the company. These financial reports are also useful for statistics bureau as a basis for government planning.

2.3. FORMS OF FINANCIAL STATEMENT

2.3.1. BALANCE SHEET

Balance sheet is also called the statement of condition or statement of financial position, provides a wealth of valuable information about the business firm.

There are three elements in balance sheet, that consist of:

1. Assets

Assets are defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transaction or event (White, Sondhi, and Fried, 1998: 16). In other words, it is defined as total company's wealth in day-to-day operating activities. There are three kinds of assets that consist of:

a. Current Assets

It is defined as items that turn over in the normal course of business within a relatively short period of time (Helfert, 2000: 18). The types of current assets are cash, account receivable, marketable securities, and inventories.

b. Fixed Assets

It is assets that are used over a longer time frame (Helfert, 2000: 18). The types of fixed assets are land, mineral resources, buildings, equipment, machinery, and vehicles.

c. Other Assets

These assets consist of deposit, patent, and various intangibles.

2. Liabilities

Defined similarly as specific obligations that represent claims against the assets of the business, ranking ahead of the owners in repayment priority (Helfert, 2000: 17).

The major categories of liabilities are:

a. Short-term Liabilities

Defined as company's financial obligations that will be paid within one year or less (Helfert, 2000: 18). Short-term liabilities consist of account payable, note payable, tax payable, prepaid revenue, accrued expense, and short-term payable.

b. Long-term Liabilities

Defined as a variety of debt instruments repayable beyond one year (Helfert, 2000: 18). Long-term liabilities consist of bond payable, mortgage payable, and loans.

3. Stockholders Equity

It represents the recorded net amount of funds contributed by various classes of owners of the business as well as the accumulated earnings retained in the business after payment of dividends (Helfert, 2000: 18). According to Du Pont systems, stockholders equity contains four elements. Preferred stocks represent a prior claim on the firm's net assets. Preferred shares are reported as the amount of cash received when they were issued. The next two components, common stock and additional paid-in capital, represent the amount received from the sale or other issuance of common stock. Reinvested (retained) earnings represent the accumulation of earnings over its corporate life, reduced by dividends paid. Stockholders equity may also contain the following additional components: treasury stock (expenditures to repurchase shares), Employee Stock Option Plan (ESOP) accruals, unrealised gains and losses, minimum pension liability.

2.3.2. INCOME STATEMENT

Income statement is defined as a statement of earning, present revenue, expense, net income, and earning per share for an accounting period, generally a year or a quarter (White, Sondhi, and Fried, 1998: 17). In one period, the total assets from one company will change; it is caused by investment activity, funding activity, and operational activity. In day-to-day activity, company produce a product and then sells that product. The selling will be resulting cash, retained earning, and dividend.

There are two elements of income statement that consist of:

1. Revenues

It is called as inflows of entity from delivering or producing goods, rendering services or other activities that constitute the entity ongoing major or central operation (White, Sondhi, and Fried, 1998: 17).

2. Expenses

It is defined as outflows from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity of ongoing major or central operation (White, Sondhi, and Fried, 1998: 17).

2.3.3. STATEMENT OF CASH FLOWS

Management decisions not only affect the profit for the period, but cause accompanying changes in most assets and liabilities, particularly in the accounts making up working capital, such as cash, receivables, inventories, and current payables. The cash flow statement is a dynamic representation in that it highlights the net changes in assets, liabilities, and ownership accounts over a specific period (Helfert, 2000: 30). This statement gives us a dynamic picture of the ultimate changes in cash resulting from the combined decisions made during a given period.

2.4. TECHNIQUE OF DATA ANALYSIS

2.4.1. FINANCIAL RATIO ANALYSIS

To make a financial statement analysis from one company, the financial analyst needs some measurement. The measurement that will be used to analyze financial statement is a ratio. According to Bambang Riyanto (1977: 263), ratio is a tool in arithmetical terms that can be used to explain the correlation between two financial data.

Ratio is used to correlate elements from assets one with another, elements from liabilities one with another, and to correlate between elements in assets and elements in liabilities. The result from elements correlation is a whole picture about financial condition from one company. In other word, financial statement analysis can be obtained from the ratio of liquidity, debt ratio, profitability ratio, and activity ratio.

2.4.1.1. LIQUIDITY RATIO

Liquidity ratio is used to measure company's ability to meet short-term obligation. Liquidity reflects the company's ability to meet the financial obligations. Every manager in one company wants to make his or her company to fulfill the financial obligation. The company is liquid when it fulfills financial obligation in an accurate time. But if company cannot fulfil the financial obligation, it means that the company is not liquid. These ratios are also important manner for long-term creditor and the shareholder to know the prospect of dividend in the future. Ratios that are usually used to measure liquidity ratio are current ratio, quick ratio, and cash ratio.

2.4.1.1.1. Current Ratio

Current ratio is used to fulfil the company's ability to fulfil short-term liabilities with using current assets or to make comparison between current assets and current liabilities. Current ratio (White, Sondhi, and Fried, 1998: 159) is formulated as follows:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Higher current ratio shows the existence of abundant cash compared with the company needs. There are some ways to increase the rate of liquidity from one company:

- a. The same current liabilities and add the amount of current assets.
- b. The same current assets and reduce the amount of current liabilities.
- c. Reduce current liabilities together with the increase of current assets.

2.4.1.1.2. Quick Ratio

Quick ratio is ratio that obtained from cash that added by marketable securities and account receivable that divided by current liabilities. Quick ratio (White, Sondhi, and Fried, 1998: 159) is formulated as follows:

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Marketable Securities} + \text{Accounts Receivables}}{\text{Current Liabilities}}$$

Quick ratio that has small number indicates that the company has high liquidity risk, but higher quick ratio shows the company's ability to control the current liabilities.

2.4.1.1.3. Cash Ratio

Cash ratio is defined as the most conservative of the measurements of cash resources for only the actual cash and securities that are easily convertible to cash are used to measure cash resources. Cash ratio (White, Sondhi, and Fried, 1998: 159) can be formulated as follows:

$$\text{Cash Ratio} = \frac{\text{Cash + Marketable Securities}}{\text{Current Liabilities}}$$

If the results from cash ratio calculation are 0.7:1 or 70%, it means every current liability as much as Rp 1.00 will be guaranteed by cash plus marketable securities as much as Rp 0.7. This ratio is also the same with current and quick ratio. The small ratio indicates that the company has higher liquidity risk and high ratio indicates that the company has a good liquidity.

2.4.1.2. DEBT RATIO

One company is called solvable when those company have enough assets to pay all of debt. Solvability from one company can be measured from the comparison between total debt and total assets. Solvability can also be obtained from comparison between total debt and total equity.

2.4.1.2.1. Debt to Equity Ratio

Debt to equity ratio is used to measure the amount of money used by a company to guarantee the total debt. This ratio (White, Sondhi, and Fried, 1998: 162) can be formulated as follows:

$$\text{Debt to Equity} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

If this ratio is at the lower level, the debtor will be happy because with the lower ratio, fund provided by stockholder is bigger and the creditor protection rate from the losing of money that they invested is also higher.

2.4.1.2.2. Debt to Asset Ratio

Debt to asset ratio is defined as a ratio that measure the percentage of using assets from creditor or a ratio that makes a comparison between total debt and total assets. This ratio (Helfert, 2000: 114) is formulated as follows:

$$\text{Debt to Asset Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

2.4.1.3. PROFITABILITY RATIO

Profitability ratio is ratio that relates profits to sales and investment (Van Home and Wachowicz, 1995: 139). A higher profitability ratio indicates the efficiency of working capital applied in resulting rate of return for the company.

2.4.1.3.1. Gross Profit Margin Ratio

Gross profit margin ratio is a ratio that measures the relationship between sales and manufacturing or merchandising costs. This ratio (White, Sondhi, and Fried, 1998: 165) formulated as follows:

$$\text{Gross Margin} = \frac{\text{Gross Profit}}{\text{Sales}}$$

The higher rate of gross profit margin means that the company has an ability to produce high profit. On the contrary, the lower level of gross profit margin indicates the lower level of company's selling ability.

2.4.1.3.2. Operating Profit Margin Ratio

Operating profit margin ratio provides information about a firm's profitability from the operations of its core business. This ratio is used to compare between net operating income and net sales. This ratio (White, Sondhi, and Fried, 1998: 165) formulated as follows:

$$\text{Operating Profit Margin} = \frac{\text{Operating Income}}{\text{Sales}}$$

The higher operating profit margin ratio means that the company has a good management to operate their company and the lower operating profit margin ratio means that the company has a poor management to operate their company.

2.4.1.3.3. Net Profit Margin Ratio

This ratio measures the comparison from net income after tax and net sales in one company. The formulation of this ratio (White, Sondhi, and Fried, 1998: 166) is:

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Sales}}$$

If net profit margin ratio increases, it means that the company's ability to produce net income after tax is good. On the contrary, the decreasing of net profit margin ratio indicates that the company has a bad performance.

2.4.1.4. ACTIVITY RATIO

Activity ratio is used to measure the effectiveness of a company in using their assets. It also describes the relationship between the company's level of operations and the assets needed to sustain operating activities. Firm operating activities require investment in both short-term (inventory and account receivable) and long-term (property, plant, and equipment) assets. The higher the ratio, the more efficient the firm operations on relatively fewer assets are required to maintain a given level of operation. The common ways to measure activity ratio are fixed asset turnover and total asset turnover.

2.4.1.4.1. Fixed Asset Turnover Ratio

The fixed asset turnover measures the efficiency of (long-term) capital investment. The formula (White, Sondhi, and Fried, 1998: 153) is defined as follows:

$$\text{Fixed Asset Turnover} = \frac{\text{Sales}}{\text{Average Fixed Assets}}$$

2.4.1.4.2. Total Asset Turnover Ratio

Total asset turnover is an overall activity that measures relating sales to total assets. The formula (White, Sondhi, and Fried, 1998: 155) is defined as follows:

$$\text{Total Asset Turnover} = \frac{\text{Sales}}{\text{Total Assets}}$$

2.4.2. DU PONT ANALYSIS

This hypothesis is also used Du Pont formulation to analyze the data. Du Pont formula is a system that is used to analyze the return on investment (ROI) and return on equity (ROE). Du Pont formula was developed by financial analysts in E.I. Du Pont de Nemours and Co. at the end of year 1930. This system correlates between activity ratios and profit margin. It can show how the ratios interact to defined the profitability. Using Du Pont method, the writer tries to calculate return on investment (ROI) and return on equity (ROE) to measure the company's financial performance.

Return on Investment (ROI) is defined as a comparison between net profit margin and total asset turnover in percentage. In other word, ROI is also described as a company's ability using their assets to achieve profit. According to Du Pont method, there are two ways to increase ROI, consists of:

1. Increase Net Profit Margin

Net profit margin is defined as a comparison between net income and sales (White, Sondhi, and Fried, 1998: 166). There are two alternatives to increase net profit margin that consist of:

- a. Try to increase the operational activity to achieve the highest revenue. The increase of sales or revenue means the increase of income from sales. On the other word, net profit margin increase when the increase of net income is higher than the increase of sales.
- b. Reduce income from sales to achieve biggest reducing of operating expense. On the other word, it can be said that decrease of sales that higher than the decrease of net income will resulting higher net profit margin.

2. Increase Total Asset Turnover

Total asset turnover is defined as a comparison between net sales and total asset (White, Sondhi, and Fried, 1998: 155). Factors that influence the increases of total asset turnover, consist of:

- a. The increase of net sales that higher than the increase of total asset will creates higher total asset turnover.
- b. The decrease of total asset that higher than the decrease of net sales is also leads the increase of total asset turnover.

The Du Pont analysis will be showed in this below figure (Brigham and Houston, 1998: 86):

Figure 2.1.

The Du Pont Scheme

