CHAPTER 1
INTRODUCTION

1.1 Research Background

Capital structure decision is the vital things in operating a business because capital structure decisions have a direct effect on the profitability of a company (Velnampy and Niresh, 2012). The capital structure is an entrance gate for the finance of the company through equity, debt, and securities (Frank and Goyal, 2007). This is the formula of equity and debt that are needed to financing the assets of the company (Pandey, 2002). The capital structure is a deliberation between debt and the capital of the company, and in creating capital structure decisions, companies can decide to fund their companies internally or externally (Ramli, Latan, and Solovida, 2019). In debt-equity issues, the decisions making commonly had done by the manager or shareholders. The manager performs on behalf of shareholders; that is, they should follow the policies that increase the shareholder's value (Bringham & Houston, 2006). According (Ehrhardt & Brigham, 2008) Capital structure is very important to maximize corporate value and performance.

Commonly, companies prefer to choose internal funding than external funding (Hamid, Abdullah, and Kamaruzzaman, 2015). According to Gathogo and Ragui (2014) when the company owners use external funding, the owners tend to choose to use the debt rather than issuing shares. Because when they choose to issue shares, the company owner will be shared with other shareholders. In contrast, if the company managers using external funding, the managers prefer to choose the issuing shares than use debt to avoid the work pressure associated with debt repayment (Ooi, 2000).

In making capital structure decisions, managers play the key role whether in issuing shares or in the use of debt. When managers only own a small percentage of ownership in the company, managers tend to utilize the profit of the company for their personal benefit and it is called managerial opportunism, because of that interest conflict is occurred between managers and shareholders (Ooi, 2000). According to agency theory conflict between managers and shareholders is considered a moral hazard (Anastasia & Lorenza, 2019). And problems with managerial opportunism have a close relationship with companies in the manufacturing sector, according to (Ghazali, Aziatul, Shafie, Nur, Sanusi, & Zurai, 2015) when the company has free cash flow, the managers can make decisions to invest in low-return investment or high-return investment. When the managers decide to invest in lower-return investment, it will make the company suffer lower growth situations, and that situation will push the managers to do earning management to boost their profit. But, when the company has a high profit, the managers tend to manage the earnings furthermore to get more benefit from its reported earnings Ghazali et al (2015).

Managerial opportunism is the manager's behavior in using the corporate fund for the manager's importance or interest based on the manager shares ownership in that corporate. (Ooi, 2000). Besides manager ownership, inside of the company ownership structure, we can also find outside block holders, the outside block holders are big percentages shareholdings of non-affiliated managers and institutions that have more than 5% of corporate ownership (Anastasia & Lorenza, 2019). Outside block holders have a task to supervise and control the un-optimal manager activities (Kararti, 2015). A big amount of total ownership shares, causing the outside block holder’s urge to decide on investment, the capital structure of the company, and take control of the cost incurred by the managers (Ooi, 2000). Commonly, outside block holders tend to use the debt funding because with using debt funding they do not need to share the ownership with other investors, and on the other hands when the company chooses to issue shares, the company will send a bad signal to the investors because the investors will think that the company need fund, so it will reduce the company values.

When the managers have ownership share, the outside block holders are expected to protect their importance by ensuring the managers did not make negative or bad actions, like using the company funds for the manager's concerns, or making an investment that creates a loss for the company owners. In previous research of Gathogo and Ragui (2014), the researcher found bad investment action that had been done by the managers like when the manager invests in a project. The experienced managers will look at benefits or profits for themselves, and they are not concern about other shareholder’s wants (Ghouma, 2017).

Managers have freedom in reporting the financial information, and with that make the manager use or give their personal opinion about a loss in using the debt funding, or make a change and adjustment on income and outcome when the investment happens (Kieshcnik & Urcan, 2006). That can happen because of the existence of the outside-block holders, the agency cost will be press and the managers try to manipulate the income and outcome of the company for their benefits (Stepanov & Suvorov, 2009). In the research of Jraporn and Gleason (2005), the agency conflict happens because of the distinction between ownership and control, companies with restricted shareholders right will have higher agency cost because the managers have the freedoms to exploit the weak shareholders right and put the personal benefits in front of the interest (Ai Hua, Yuan, and Na, 2011).

One of the factors that can affect the capital structure decisions in a company is the institutional ownership because the institutional ownership can increase the company values (Purba & Africa, 2019). Institutional investors are professional investors that have an impact on the company’s capital structure decisions directly and indirectly, because they have a lot of equity and personnel, so their vote has a big impact on the result of the decision.

Company characteristics affect the capital structure decision of the company (Eriotis, Vasiliou, and Neokosmidi, 2007). Commonly, company characteristics are defined as a certain component in the company that reflects the company's fundamental condition (Eriotis et al., 2007). According to Anastasia and Lorenza (2019) company characteristics and stock market conditions also affecting capital structure decisions. From research Ooi (2000) shows that company characteristics are the control variable consisting of Tax Burden, Default Risk, Target Debt Ratio, Firm Size, Growth Rate, and Profitability.

Trade-off theory and pecking order theory are used to test the effect of managerial opportunism on the capital structure decisions of the company. The trade-off theory comes from a debate about the Modigliani and Miller theory (Mutamimah & Rita, 2009), where the company can determine the optimal capital structure when there is a balance between the benefits of using debt and the cost of using debt. This theory consists of various factors like taxes, the agency cost, symmetrical information, and the cost of financial difficulties (Cevheroglu-Acar, 2018). When managers have more information than investors, the funding decisions are adjusted to the preferences of investors and managers, resulting in the pecking order theory (Brealey, Myers, and Allen, 2009).

Pecking order theory comes out because of the emergence of asymmetry information that had been explained by Myers & Majluf (1984) that a manager who has much information will manage and prospect the company rather than the principal. Asymmetric information can drive the funding selection namely the internal and external sources including agency conflicts (Hamid et al., 2015). According to Frank and Goyal (2008) companies like to use internal funding, because funds are raised without sending negative signals that can reduce the stock prices of the company, so the company prefers to use retained earnings than debt. And when the company uses external funds, they tend to use debt than using equity. The pecking order theory has an impact on capital structure decisions because investors prefer to use debt than issuing shares, where the manager's interests are against the investor’s wishes (Anastasia & Lorenza, 2019).

1.2 Research Problems

Based on the background above, the research questions are as follows:

1. Does managerial ownerships affect the capital structure decision of manufacturing sector companies listed on the Indonesia Stock Exchange?

2. Does managerial outside block holders affect the capital decision structure of manufacturing sector companies listed on the Indonesia Stock Exchange?
3. Does institutional ownership affect the capital structure decision of manufacturing sector companies listed on the Indonesia Stock Exchange?
4. Does a company characteristic affect the capital structure decision of manufacturing sector companies listed on the Indonesia Stock Exchange?

1.3 Research Objectives

The objective of the study is to investigate:

1. To determine the effect of managerial ownerships on the capital structure decisions of manufacturing sector companies listed on the Indonesia Stock Exchange.
2. To determine the effect of outside block holders on the capital structure decisions of manufacturing sector companies listed on the Indonesia Stock Exchange.
3. To determine the effect of institutional ownership on the capital structure decisions of manufacturing sector companies listed on the Indonesia Stock Exchange.
4. To determine the effect of company characteristics on the capital structure decisions of manufacturing sector companies listed on the Indonesia Stock Exchange.

1.4 Significance of the Study

In this study, expected the result of research can be input for some parties that are:

1. For Academics

This research is expected to become information, and knowledge for academies as well can be a guidance for further research development especially on the financial.

2. For Management

For companies that optimize the capital structure, the policies taken can avoid managerial opportunism by observing the partiality of managers towards themselves or the company owners.

3. For Investors

This research would be useful in giving information about investment decisions for investors and a more comprehensive understanding regarding the composition of the ownership structure and the decision on the company's capital structure because with an optimal capital structure and ownership structure, managerial opportunism tends to be avoided.

1.5 Writing Structure

Systematic of this writing is divided into five chapters that will be arranged systematically as follows:

CHAPTER 1: INTRODUCTION

Explain the background of the problem, the formulation of the problem, the purpose of the study, the significance of the study, and the writing systematic.

CHAPTER 2: LIBRARY REVIEW

This section contains the theoretical basis, previous research that is relevant to the problem addressed within the study, hypotheses development, and analysis models.

CHAPTER 3: RESEARCH METHODS

Describe the research design, variables identifications, operational definition, variable measurement, types of data and sources, tools and methods of data collection, population, samples and sampling techniques, and data analysis techniques.

CHAPTER 4: ANALYSIS AND DISCUSSION

Regarding the character of the research, the descriptive statistics of research variables, the results of data analysis, hypothesis testing, and discussion

CHAPTER 5: CONCLUSIONS AND SUGGESTIONS

Contain conclusions from the results of the hypothesis testing and discussion of finding research conducted. To give suggestions in the form of problem-solving ideas that originate in the discussion of the research findings that are useful for the company and subsequent research.