# CHAPTER II

# LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

## 2.1 Dividend Policy

### 2.1.1 Dividend Definition

PSAK number 23 year 2014 defines dividends as the distribution of profits to shareholders in accordance with the proportion of their ownership over certain capital. Dividend is profit sharing conducted by a company to shareholders. Dividends are shared in equal amounts for each share and the amount of dividends depends on the remaining profits (after some deductions) and also depends on the decision of the General Meeting of Shareholders (GMS).

### 2.1.2 Dividend Policy Definition

Dividend policy according to Brigham, et al (2009) is a decision of allocating profits, whether distribute it or hold it for reinvestment in the company. The allocation of profit as retained earnings and dividend payout is the key aspect of dividend policy. The dividend policy is a decision to determine how much company's revenue will be paid to shareholders, reinvested or held in the company.

According to Van Horne, et al (2012) dividend policy is an integral part of the company's funding decisions. The main aspect of dividend policy is determine the appropriate allocation of earnings between dividend payments and the additional retained earnings that hold by company. Based on the understanding above, it can be concluded that dividend policy is a decision to determine how much profit will be distributed to shareholders rather than profit to be retained. The policy is very important for the company because dividend payments are likely to affect the value of the firms and retained earnings that are usually the largest and most important internal source of funds for corporate growth.

According to Aharony and Swary (1980), in dividend policy there is a tradeoff and choice between sharing profits as dividends or being invested as retained earnings. If the company chooses to distribute profits as dividends then the growth rate will decrease and it will give negative impact on the company's shares. On the other hand, if the company does not distribute dividend, the market will give a negative signal to the prospect of the company. Increase in dividend gives a sign that the company in the future can be profitable and the decrease of dividend shows the pessimistic view of the prospect of the company in the future.

### 2.1.3 Types of Dividend

According to Stice, E.K., Stice, J.D. and Skousen, K.F (2009), there are some types of dividends:

1. Cash Dividend

This type of dividend is the dividend that most often chosen by the management of a company. Cash dividend is a dividend that is given to shareholders by using cash. For the company, this cash dividend will reduce the retained earnings account balance, while for the investor, the cash dividend will generate cash and be recorded as dividend income.

2. Property Dividend

This type of dividend is a distribution to the outstanding shareholders in the form of assets other than cash. What is usually shared is an asset in the form of securities from another company owned by the company. This type of dividend is done in a private company.

3. Share Dividend

The company may distribute additional shares of the company to the shareholders as stock dividends.

4. Liquidation Dividend

This type of dividend is a dividend that reflects a return to shareholders on a portion of the paid up capital. This dividend represents a return on the recorded investment by reducing the share premium.

### 2.1.4 Theory of Dividend Policy

Brigham and Houston (2009) mentions there are three theories that explain about dividend policy:

1. Dividend Irrelevance Theory

   This theory is known as Modigliani-Miller Model (M-M's Model). This theory states that the company's dividend policy has no effect on the company's value, stock price, or cost of capital. Corporate value is only influenced by the amount of profit that can be generated from managing asset, not influenced by the amount of profit allocated into dividends to be distributed to shareholders. Moreover Modigliani-Miller argue that ultimately investors will tend to re-invest their dividends; can be in the same company or in company that has almost same risk.

2. Bird in The Hand Theory

   This theory states that investors prefer dividend payouts likened to "one bird in hand is worth more than two birds in the forest". According to this theory, income that can be gained through dividend distribution has more definite value than expected income from capital gains. This is happened because dividend distribution are controlled by the firms while capital gains are controlled by the market.

3. Tax Preference Theory

    This theory suggests that investors do not really like dividends because of the imposition of tax on dividends and capital gain. But for capital gains tax can be delayed because tax will be paid after the capital gain is realized.

There are also several theories regarding dividend policy:

1. Signaling Hypothesis

    The theory stated that investors prefer dividends rather than capital gains, can be proved by empirical fact that if there is an increase in dividend, it will then be followed by a rise in stock prices and vice versa. On the other hand, Modigliani-Miller argues that an increase in dividends (more than usual) is a "signal" to investors that the management company predict an increase in future earnings and vice versa.

    Dividend signaling theory was first initiated by Bhattacarya (1979). Dividend signaling theory underlies the notion that changing in cash dividend gives a signal that results in a stock price reaction. This theory explains that the information about cash dividend is considered by investor as a sign about company's prospect in the future. If there is an increase in dividends, it will be considered as a positive signal that means the company has a good prospects, causing a positive stock price reaction. If the dividends paid decrease, it will be considered as a negative signal which means the company does not have a good prospect in the future, causing a negative stock price reaction.

    The more the company is able to earn bigger profit, then theoretically the company will be able to share more dividend. Distributing a large dividend will attract investors to invest in the company because they see that the company has enough profit to be distributed as return of their investment in the company. It becomes an indicator that company's profitability will improve in the future.

2. Clientele Effect Theory

This theory states that different “clientele” (group) shareholders will have different preferences on the company's dividend policy. Group of shareholders who need income in the near future will preferring high levels of dividend payout ratio (DPR) and vice versa.

3. Residual Dividend Policy

This policy states that company pays dividend only if there is an excess of funds on the company's earnings which is used to finance future planned projects. The basis of this policy is that investors prefer the companies to reinvest earnings instead of distributing it in the form of dividends if the profit reinvested can generate a higher return than the average return that investors can generate from other investments with the same risks. (Dini Rosdini, 2009: 4)

## 2.2 Agency Theory

Agency Theory is a theory that studies the relationship between agents and principal. In this case the management company is the agent and the shareholder is the principal. According to Jensen and Meckling (1976), agency theory is the contradictory interest of management and shareholders which can lead into a conflict. Such conflicts can occur because managers tend to give priority on his personal interests rather than the interests of shareholders.

Anthony and Govindarajan (2005) explain that agency theory assumes all individuals act for their own benefit. The agency theory calls the agent as the management of the company while the principal is the shareholder. Agents are assumed not only interested with financial compensation but also everything that being engage in the relationship of the agency, such as many leisure time, attractive working conditions, and flexible working hours. Principals are assumed to be interested only in financial returns obtained from what they invest in the company

Moreover, according to Anthony and Govindarajan (2005) an agency problem occurs when management does not own a majority share of the company. Shareholders want managers to work with the goal of maximizing shareholder wealth. Agencies can act not to maximize shareholder wealth but for their own prosperity. If the condition occurred, means there is agency conflict. To ensure that manager works with the purpose of shareholder prosperity, shareholders must pay a fee called agency cost. The agency cost includes expenses to oversee activities of managers, expenditures to create an organizational structure that minimizes undesirable manager actions, and opportunity costs arising from conditions in which managers cannot immediately make decisions without shareholder approval.

Pearce II, J.A. and Robinson, Jr., R.B., (2008) define agency relationship as a contract in which one or more person (principals) involving another person (the agent) to do some work on their behalf. In general, the company owner wants to maximize the value of the stock. However, when manager owns most of company's shares, manager will undoubtedly choose a strategy that generates stock appreciation. When managers are not as partners or owners, managers will prefer strategies that increase their own personal compensation while owner's interest will be ignored. The cost of agency problems and the cost of actions taken to minimize agency problems are called agency costs. The cost of the agent is found when there is a difference of interests between shareholders and managers, superiors with subordinates, or even between one managers and other managers.

Jensen and Meckling (1976) state that there are three categories of agency cost:

1) The cost of monitoring (monitoring cost), which is the cost incurred in order to oversee the activities undertaken by the manager to limit the irregularities that is possibly done by the management.
2) The cost of incentive compensation (i.e. bonding costs), which is the expenditures for principal control towards agent so that the opportunity given to the management in term of resources spending will not harm the owner.
3) The cost of residual cost, which is the cost incurred due to the conditions in which the manager can not immediately make a decision without shareholder's consent. This condition happened when the management of the company loss an opportunity to earn profits because there is limitation in decision making or there are different decisions making between the principal and the agent.

## 2.3 Factors Affecting Dividend Policy

Shah, Ullah, and Hasnain (2010) provide an empirical evidence by doing research in Pakistan that show a positive influence between ownership structure and dividend policy. Moreover, Nuringsih (2005) provides an empirical evidence by doing research in Indonesia that shows there is positive and significant impact of ownership structure to dividend policy in Indonesia.

Basil Al-Najjar Erhan Kilincarslan (2016) provides the empirical evidence by doing research in Turkey that ownership structure has a negative relationship on dividend policy. Harada and Nguyen (2011) studied the link between ownership structure and dividend policy in Japan. Their results showed that the presence of controlling shareholders has a negative effect on dividend payouts. Controlling shareholders compensate minority shareholders with low dividend payouts.

Berzins et al. (2012) investigated the effect of controlling ownership by studying private firms in Norway. It was argued that agency problems should generally be worsened for private firms, as they have no external (public) monitoring mechanisms. They also found that minority shareholders receive higher dividends when agency conflict is higher. Mollah (2007) by doing research in Bangladesh argues firms pay higher amount of dividends as monitoring and bonding package when insiders hold a lower percentage of common stock and or greater number of common stock held by outsiders to reduce agency cost. Al-Kuwari (2009) shows that dividend policy is significantly related to firm size and firm profitability. He notes that, in the GCC (Gulf Cooperation Council) region, firms pay dividends to resolve agency problems and to preserve firms' reputation.

Al-Kuwari (2009) shows that dividend policy is significantly related to firm size and firm profitability. Firm size describes the size of company that can be indicated by total assets, total sales, average total sales and average total assets. Thus, the firm size is the size of asset owned by the company.

Eddy and Seifert (1988), Jensen et al. (1992), Redding (1997), and Fama and French (2001) indicated that large firms distribute a higher amount of their net profits as cash dividends, than small firms do. Holder et al. (1998) revealed that larger firms have better access to capital markets and find it easier to raise funds at lower costs, allowing them to pay higher dividends to shareholders. This demonstrates a positive association between dividend payouts and firm size.

Firm profitability also becomes factor that related to dividend policy. Jensen et al., (1992); Han et al., (1999); Fama and French, (2001) provide evidence that a firm's profitability is a significant and positive explanatory variable of dividend policy, the higher the return on equity of a company, the higher the dividend will be given. Glen et al. (1995), showing that dividend payout rates in developing countries are approximately two-thirds of those in developed countries. Moreover, emerging market corporations do not follow a stable dividend policy; dividend payment for a given year is based on firm profitability for the same year. As a proxy, firm profitability is measured by the return on equity (ROE) (Aivazian et al., 2003, Ap Gwilym et al., 2004).

### 2.4 Measurement of Dividend Policy

According to Al-Kuwari (2009) dividend payout ratio indicates the percentage of profits distributed by the company among shareholders out of the net profits, or what remains after subtracting all costs (e.g., depreciation, interest, and taxes) from a company's revenues. Based on some existing researches, dividend payout ratios used as a proxy of dividend policy (Lloyd,1985; Jensen et al., 1992; Holder et al., 1998; Chen et al., 1999; Mollah et al., 2002).

According to Al-Kuwari (2009), dividend payout ratio is used as proxy of dividend policy (rather than dividend per share and dividend yield) for two reasons. Firstly, the dividend payout ratio takes into consideration both dividend payout and dividend retention. Such a consideration is essential, because the issues in this study are concerned with the relationship between the dividend payout and the amount of cash retained in the business, as well as how this perhaps can reduce agency costs and encourage future investment. Secondly, dividend per share and dividend yield were considered unsuitable because neither takes into account the dividend paid in relation to the income level.

### 2.5 Insider (Managerial) Ownership

Insider ownership is a manager that also becomes an owner of a company or all parties who have the opportunity in decision making and have direct access to information within a company. Based on the explanation of the Law of the Republic of Indonesia No. 8 of 1995 Article 95, the capital market defines the insider as follows:

a) A commissioner, director, employee of the company
b) Major shareholder in the company
c) Individuals whose positions or relationships is inside the company and know inside information of the company.

Managerial ownership is the percentage of share owned by management that actively participates in the board of commissioners and the board of directors. Ruan, Tian, and Ma (2011) defines insider ownership as the fraction of shares, not including options, held by officers and directors of the board.

According to Ruan, Tian, and Ma (2011), an increase of managerial ownership helps to connect the interests of insiders and shareholders, and leads to better decision-making and higher firm value. However, when the equity owned by management reaches a certain level, further increase of managerial ownership may provide managers with sufficient shares to pursue their own benefit. When managerial ownership approaches a considerably high level, the agency problem can be largely mitigated due to the full alignment between the interests of managers and shareholders.

## 2.6 Existing Research

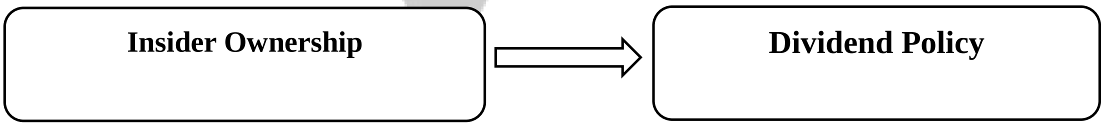
**Table 2.1 Existing Researches**

| Year | Author(s) | Result |
|---|---|---|
| 1976 | Jensen and Meckling | Agency cost will be low in companies with high insider ownership. |
| 1988 | Eddy and Seifert | Large firms distribute a higher amount of their net profits as cash dividends, than small firms do. |
| 1992 | Jensen et al | Firm size and firm profitability affects dividend policy. |
| 1997 | Redding | Dividend policy is affected by firm size. |
| 1998 | Holder et al. | There is positive association between dividend payouts and firm size. |
| 1999 | Han et al | Firm's profitability is a significant and positive explanatory variable of dividend policy |
| 2001 | Fama and French | Firm size and profitability affects the distribution of dividend. |
| 2003 | Taswan | The more shares hold by insider ownership the more tendency of management to hold the dividend payment. |
| 2005 | Nuringsih<br>(Studied in Indonesia 1995-1996) | Insider ownership gives positive and significant impact to dividend policy, debt policy gives negative and significant impact to dividend policy, ROA gives negative and significant impacts to dividend policy, and firm size gives positive but not significant impacts to dividend policy. |
| 2007 | Mollah<br>(Studied in Bangladesh) | Firms pay higher amount of dividends as monitoring and bonding package when |

| | | |
|---|---|---|
| | | insiders hold a lower percentage of common stock and or greater number of common stock held by outsiders to reduce agency cost. |
| 2009 | Al-Kuwari<br>(Studied in GCC) | Dividend policy is significantly related to firm size and firm profitability. |
| 2010 | Shah et al.<br>(Studied in Pakistan) | Ownership structure positively impacts dividend policy. |
| 2011 | Harada and Nguyen<br>(Studied in Japan) | The presence of controlling shareholders has a negative effect on dividend payouts. |
| 2012 | Berzins et al.<br>(Studied in Norway) | Agency problems should generally be worsened for private firms, as they have no external (public) monitoring mechanisms. Minority shareholders receive higher dividends when agency conflict is higher. |
| 2012 | Manos et al.<br>(Studied in India) | Indian business groupings prefer not to share dividends. |
| 2013 | Su et al.<br>(Studied in China) | Firms that have higher related party transactions pay lower dividends in China |
| 2016 | Basil Al-Najjar Erhan Kilincarslan<br>(Studied in Turkey) | Ownership structure has a negative relationship on dividend policy. |

## 2.7 Conceptual Framework

**Picture 2.1 Conceptual framework of the research**



## 2.8 Research Hypothesis

Jensen et al (1992) argue that managerial ownership has negative impact on dividend payout policy. Managers would rather preserve earnings instead of distributing them to shareholders to ensure the growth of the company and to maximize their personal benefits. Chen et al (2005), focusing on Chinese firms, also find a negative relationship between managerial ownership and dividend policy.

There are also several studies that show relationship between ownership structure and dividend policy around the world. Basil Al-Najjar Erhan Kilincarslan (2016) in Turkey, Harada and Nguyen (2011) in Japan, Berzins et al. (2012) in Norway, Mollah (2007) in Bangladesh, and Al-Kuwari (2009) in GCC provide empirical evidence that ownership structure has negative relationship on dividend policy. According to Al-Kuwari (2009) firms pay dividends to resolve agency problems and to preserve firms' reputation. Berzins et al. (2012) stated that minority shareholders receive higher dividends when agency conflict is higher.

On the other hand, Shah, Ullah, and Hasnain (2010) provide an empirical evidence by doing research in Pakistan that show a positive influence of ownership structure to dividend policy. Moreover, Nuringsih (2005) provides an empirical evidence by doing research in Indonesia that shows there is positive and significant impact of ownership structure to dividend policy in Indonesia. Nuringsih (2005) stated that the more involvement of manager as insider ownership, make the assets of manager are not optimally diversified and they will require high dividend payment as the return from their investment. Moreover, ownership structure in Indonesia is relatively concentrated or owned by family so that they tend to pay higher dividend.

If the manager's behavior likes high dividend payment, then the behavior of managers represent "Bird in The Hand Theory". This theory states that investors prefer dividend payouts likened to "one bird in hand is worth more than two birds in the forest". According to this theory, income that can be gained through dividend distribution has more definite value than expected income from capital gains. This is happened because dividend distribution are controlled by the firms while capital gains are controlled by the market. Based on the reason above, author formulates hypothesis as follows:

**H1 : Insider ownership positively impacts dividend payment in Indonesia.**