CHAPTER I

INTRODUCTION

1.1 Background

Inside the company, principals (shareholders) and agents (managers) have many importances. Shareholders want to get a payout from the company as a result from company's performance while managers want to get private benefits, e.g. building their companies, spending cash on perquisites, or make another investment. That's called the agency conflicts. Based on Jensen and Meckling's (1976), mitigating agency conflicts between managers and shareholders will create an agency cost charged by each of them. For principals, they can reduce impotence differentiation by monitoring agent's expenditures (monitoring cost) and lessen the welfare (residual loss). Agents will reduce importance differences by expanding resources (bonding costs). In this case, dividend can help the company to solve the agency conflicts. Dividend is a flow of payment made by a company to shareholders, either in the form of cash or shares (Ross et al, 1999 in Rosdini, 2009). The dividend paying to shareholders depends on dividend policy in every company.

Dividend policy is a policy that relates to dividend payment by company, that is how much dividend will be distributed and retained earnings for company's interest (Levy and Sarnat, 1990). Dividend policy determined by The General Meeting of Shareholder will affect the amount of cash distributed as dividends. This is called the dividend payout ratio (DPR). The amount of dividend payout ratio (DPR) also based on various factors, but in a world of asymmetric information and agency problem, it is argued that the important determinant that will affect the company to pay dividend are company's cash position that reflected in free cash flow and company's life cycle (Lestari, 2012). According to Jensen's (1986), free cash flow is a cash which left over after all projects generate positive net present value. The companies will distribute dividend when they have free cash flow. Based on Rosdini (2009), the greater free cash flow available in company, the more healthy that company will be because the company has cash available for growth, debt repayments and dividend. The distribution depends on company's life cycle stage. Generally, companies in mature stage tend to have free cash flow higher than companies in growth stage. Companies in mature stage have little opportunities to invest in profitable projects. They used cash available to fund abundant investment opportunities (Thanatawee, 2011). It makes companies in growth stage tend to avoid paying dividend. According to De Angelo et al (2006), companies in mature stage are the best candidate to pay dividend because they have higher profitability and fewer attractive investment opportunities.

From 1994 to 2006, The Indonesia Corporate Act had given freedom for every company to pay dividend in which allow them to pay dividend as long as the cash was available. The company which had negative retained earnings and negative net income can also pay dividends to shareholders (Lestari, 2012). Since this policy came, there are two problems appear. Firstly, the companies in mature stage always get profit but not paying the dividends to shareholders. Secondly, companies which suffered in a financial loss precisely paying the dividends to attract investors as the motivation. Interestingly, dividend payment in Indonesia tends to decrease year by year in this period. A recent study by Lestari (2012) explicated that the percentage of dividend payment in Indonesia declined from 1994 until 2006 although in that period there no law enforcement for that case. The phenomenon of the deceased dividend payment in Indonesia is not the first time. Fama and French (2001) in Lestari (2012), the first researchers studying about the dividend payment phenomena said that dividend payment in U.S decrease from 66,5% in 1978 to 20,8% in 1999. It is referred to as disappearing dividends. Grullon and Michalely (2002) in Lestari (2012) use the dividend/share repurchase substitution hypotheses to explain the decision for the dividend payment. Based on Amihud and Li's (2006) study, their research explained the strong declines in stock price reaction to the changes of dividend announcement since 1979, firm with high institutional holdings were less likely to raise their dividend. According to Lestari (2012), U.S data could be used to explain the dividend decision explained by the three researchers above.

In 2007, The Indonesia Corporate Act had amended and imposed limitations in dividend payments. Only companies with positive profit balance are allowed to pay. The company shall set aside a certain amount of the net profits every financial year as reserve from the paid capital up, retained earnings and net assets at least 20%. For a company who does not achieve the requirement can only use this reserve to cover losses (Indonesia Corporate Act, article 70).

There are several previous studies about dividend payment. A research by Grullon Michaely (2002) titled “Are Dividend Changes a Sign of Firm Maturity?” resulting that dividend increases and other cash payouts are an integral feature of the process a firm undergoes as it moves from growth phase to more mature phase. Typically, in a growth phase, a firm has many positive NPV projects available that earns large economic profits. It also has high capital expenditures, low free cash flows, and experiences rapid growth in its earnings. The more the firms develop, the more competitors come. It will influence the firm’s market share and its economic profits. In this transition phase, the firm’s investment opportunity set starts shrinking, its growth begins to slow down, the capital expenditures decline, and the firm starts generating larger amounts of free cash flows as well.

Other researcher, Rosdini (2009) doing the research about “The Effect of Free Cash Flow to Dividend payout ratio (DPR)” gave the result that free cash flow affect the dividend payout ratio (DPR). From these results concluded that the free cash flow can be used as an indicator in determining a company's dividend policy.

DeAngelo et al (2009) conduct a research titled “Dividend Policy and the Earned / Contributed Capital Mix: a test of the life-cycle theory”. Consistent with a life-cycle theory of dividends, the fraction of publicly traded industrial firms that pays dividends is high when retained earnings are a large portion of total equity (and of total assets).

Research by Wiagustini (2009) titled “Investment Opportunity, Institutional Ownership, Cash Flow, Company Life Cycle to Dividend Policy and Stock Return” resulted that the investment opportunity negatively influenced the dividend policy, while the cash flow did not influence the dividend policy determination; ownership structure did not influence dividend policy determination; the company life cycle stages influenced the dividend policy determination; dividend policy determination influenced company share return; investment opportunity did not directly influence to share return; the cash flow negatively influenced to share return; company institutional ownership negatively influenced the company share return; and company lifecycle stages negatively influenced the company share return.

Denis and Osbov (2008) did a research in “Why Do' Firms Pay Dividends? International Evidence on the Determinants of Dividend Policy”. Their research cast doubt on signaling, clientele, and catering explanations for dividends, but support agency cost-based lifecycle theories. They also found that larger and more profitable firms and those with a greater proportion of earned equity are more likely to pay dividends, while the effect of growth opportunities on the likelihood of dividend payments is mixed.

Thanatawee (2011) conducted a research about “Life-Cycle Theory and Free Cash Flow Hypothesis: Evidence from Dividend Policy in Thailand”. He examined dividend policy of Thai listed companies over the period 2002-2008. The results show that larger and more profitable firms with higher free cash flows and retained earnings to equity tend to pay higher dividends. The findings from this paper also provide much support for the free cash flow and life-cycle hypothesis.

Lestari (2012) made a research about “Determinants of Dividend Decision: Evidence from the Indonesia Stock Exchange”. This study aims at finding the determinant of dividend decision, i.e. the decision to pay or not to pay dividend. Qualitatively, dividend payers are more profitable, bigger, have less growth and have higher ratio of retained earnings to total assets than that of non payers. Quantitative analysis using logistic regression shows that probability of firms paying dividend are higher when firms have higher ratio of retained earnings to total assets (RE/TA). This study *provides support to agency-based life cycle theory.*

This study will use the Indonesian manufacturing company listed in Indonesian Stocks Exchanges. There are three kinds of Indonesian manufacturing company listed on the Indonesian Stock Exchange; basic industry and chemical sectors, various industry sectors, and industry consumption goods sectors. The number of Indonesian manufacturing companies increased significantly from year to year. Data from Central Bureau of Statistics 2012 said that there are 131 manufacturing companies that listed in IDX, increasing 4.88% from 2011 and 3,51% in 2011. These companies being listed relatively long are likely to have a higher free cash flow because they are in the mature stage than the company listed newly. The growth of those companies and the changes in the Indonesia Corporate Act that not followed by mandatory regulation is interesting to examine.

Based on the previous study, this research will examine the dividend policy using company's cash position and company's life cycle because first order determinant of the decision to pay or not to pay dividend is the need to distribute free cash flow and the agency-based life-cycle theory also explained that the distribution of free cash flow to shareholder follows firm's life cycle stage. This paper will test whether dividend policy proxied by dividend payout ratio (DPR) related to the proxy of free cash flow i.e. the ratio free cash flow to the total asset (FCF/TA). The FCF/TA ratio will predict the positive relationship between dividend payout ratio and free cash flow. For the proxy of company's life cycle i.e. the ratio retained earnings to total equity (RE/TE). The RE/TE will predict dividend payout ratio according to the company's stage.

1.2 Research Problem

Based on the changes in the Indonesia Corporate Act 2007, it imposes limitations in dividend payments. Only companies with a positive profit balance can pay dividend. The changes in the Indonesia Corporate Act not followed by mandatory regulation to pay dividend will make company didn't have any responsibility to pay dividend. There are two possibilities here. Firstly, Indonesian manufacturing companies in mature stage do not want to pay dividends because the mandatory regulation is not there, and secondly, they want to pay dividend to reduce agency problems. It is possible if company with higher free cash flow does not pay a dividend to expand their business. Therefore, this research tries to investigate the impact of free cash flow and life cycle theory to dividend policy proxied by dividend payout ratio (DPR), by developing the following problem questions :

1. Does free cash flow as proxied by FCF/TA positively affect dividend policy?
2. Does company's life cycle as proxied by RE/TE positively affect dividend policy?

1.3 Research Limitation

This research will only research all of manufacturing companies that listed in Indonesia Stock Exchange (IDX) from 2008 to 2011.

1.4 Research Objectives

By doing this research, the researcher is trying to know the impact of free cash flow and life cycle theory to dividend policy in the Indonesian manufacturing company.

1.5 Research Benefit

1. For Researcher

   This research can be a guideline for other researcher for the next research related to dividend policy with empirical evidence.

2. For Reader

   This research can give knowledge about the impact of free cash flow and life cycle theory to dividend policy in the Indonesian manufacturing company.

1.6 Research Analysis

1. Calculate retained earnings to total equity (RE/TE).
2. Calculate free Cash Flow to total assets (FCF/TA).
3. Calculate dividend payout ratio (DPR).
4. Classical assumption testing.
5. Input and process data to the multilinear regression using IBM SPSS.
6. Hypothesis testing using F and t-test.

1.6 Systematic of Writing

Research was prepared by systematic as the following:

CHAPTER I INTRODUCTION

Chapter I is an introduction in the preparation of the research which consist of background, research problem, research limitation, research objectives, research benefit, research analysis and systematics of writing.

CHAPTER II LITERATURE REVIEWS

Chapter II contains literature review outlines the theoretical basis and previous research to be used as a reference, framework, and hypotheses development.

CHAPTER III RESEARCH METHODOLOGY

Chapter III consists of population and sample, data gathering, measurement of variables, and data analysis technique.

CHAPTER IV DATA ANALYSIS AND DISCUSSION

Chapter IV contains the results of processing and data analysis that has been calculated at the previous chapter and being observed to find the conclusion.

CHAPTER V CONCLUSION

Chapter V contains conclusion of the research that has been done, limitation that researcher found and suggestion for the next research.