

CHAPTER II

LITERATURE REVIEW

2.1 Agency Theory

According to Brigham and Houston (2006), agency theory is a condition which manager is authorized by the owner of the company to make decision, where it will create potential conflict of interest. Agency relationship occurs when one or more individuals who are referred as principals hire individuals from other organizations, which is referred as agents, to perform services and delegate the authority to make decisions for agents. Managers and shareholders do not always have the same goals, so it has potential conflicts of interest.

Agency theory, the analysis of such conflicts, is now a major part of the economics literature. The payout of cash to shareholders creates major conflicts that have received little attention. Payouts to shareholders reduce the resources under managers' control, thereby reducing managers' power, and making it more likely they will incur the monitoring of the capital markets which occurs when the firm must obtain new capital. Financing projects internally avoids this monitoring and the possibility the funds will be unavailable or available only at high explicit prices (Jansen, 1986).

Managers have incentives to cause their firms to grow beyond the optimal size. Growth increases managers' power by increasing the resources under their control. It is also associated with increases in managers' compensation, because changes in compensation are positively related to the growth in sales. The

tendency of firms to reward middle managers through promotion rather than year-to-year bonuses also creates a strong organizational bias toward growth to supply the new positions that such promotion-based reward systems require (Baker in Jansen, 1986).

There are several alternatives to reduce agency cost. firstly, management increase company stock ownership so manager will feel the direct benefits of the decisions taken and if there are any loss that arising, it is a consequence of making wrong decision. Stock ownership by management is an incentive for managers to improve the company's performance. Secondly, using the dividend payout ratio (DPR), thus not available pretty much free cash flow, so that management did not have the opportunity to invest that do not comply with the wishes of shareholders. Thirdly, institutional investors as monitoring agents stated that distribution of shares among shareholders from outside the institutional investors and shareholder dispersion can reduce agency cost. This is because ownership represents a source of power that can be used to support or oppose the presence of management.

2.2 Dividend Theory

2.2.1 Definitions of Dividend

Dividends are a form of payment made by a company to shareholders, either in the form of cash or shares. Dividends are also said to be a "revenue component" of investment return on the stock Ross et al (1999) in Rosdini (2009). Dividend distributed as profits from company. Dividends are determined by the

general meeting of shareholders and kinds of the payment depends on the company policy.

According to Gitman (2003), cash dividends paid an assessment of a stock investor. Cash dividend reflects the cash flows to shareholders and inform the firm's current performance and future. Since retained earnings is a form of internal funding, the decision regarding the dividend may affect the external financing needs of the company. Thus, the greater the cash dividends paid by the company, the greater the amount of external financing needed through debt loan or sale of shares.

Study by Grullon on et all (2002) explain that dividend increases will convey good news and dividend decrease convey bad news. There is a positive relationship between dividend changes and the price reaction to dividend changes. The dividend increasing firms do not increase their capital expenditure and experience a decline in profitability in the years after dividend change. The positive market reaction to a dividend increase is significantly related to the subsequent decline in systematic risk. The dividend increasing firms with the largest decline in systematic risk also experience the largest increase in price over the next three years, suggesting that the market reaction to dividend changes may not incorporate the full extent of the decline in the cost of capital associated with dividend changes. This decline in risk result in an economically significant decline in their cost of capital. They shown that this decline in the cost of capital can account for the positive price reaction to the dividend-increase announcement, even when the dividend change conveys information about a decline in the firm's

growth prospects. The price reaction to dividend increases and dividend decreases suggests that investor, interpret these changes as positive or negative news, as the case may be about the firm. Firms increase dividends only when they are sure they can sustain the higher dividends-that is, when they are sure they can sustain the higher dividends- that is, when they have long-run target payout ratios in mind. Dividend-increasing firms maintain their current level of capital expenditures in the future while the level of cash and short term investments on their balance sheet declines. Dividends have long been an enigma. Since they are taxed at a higher rate than capital gains, the common presumption is that dividends are less valuable than capital gains.

There are 4 types of dividend by Kieso et al 2007 :

1. Cash dividends are dividend distribution in the form of cash that usually expressed in dollars or percentages.
2. Property dividends are dividend payment using company's assets other than cash.
3. Liquidating dividends are dividend payment not based on retained earnings or earnings.
4. Stock dividends are dividend in the form of shares to shareholders.

2.2.2 Dividend Policy

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). De Angelo and De Angelo (2006) propose that optimal payout policy is driven by the need to distribute the firms's free cash flow.

Dividend policy determined by The General Meeting of Shareholder will affect dividend payments for each company that makes differences on its cost. According to Gitman (2003), factors that influence dividend policy is debt covenants, liquidity, cash position, company's prospects, and the control of the shareholders who own the majority shares of the company.

When companies choose to distribute profit in the form of dividends, it will reduce retained earnings and the total internal funding sources. Conversely, if the company choose to withhold profit, then the ability of the formation of internal funds will be greater (Rosdini, 2009). Therefore, appropriate dividend policy will create a good company's stock price.

Study by Grullon et all (2002) explain that changes in dividend policy convey news about future free cash flow. The changes in dividend policy relate to changes in a firm's life cycle. Their result indicate that dividend payout ratio (DPR) of dividend-increasing firms do increase permanently, suggesting that these firms are indeed able to maintain their higher dividend.

There are several theories about dividend policy :

1. Irrelevance Theory

This theory is said to be irrelevant because dividend policy does not affect the value of the company . Modigliani and Miller (1961), explaine that the company's value only determined by the company's earnings and risk

expectation. Modigliani and Miller (1961) argue for dividend irrelevancy under the perfect market assumption and dividend would not increase shareholder wealth. Therefore, the amount of dividend payment will not affect company's value. Companies are judged based on profits from asset's expected.

2. Bird-in-the-hand Theory

Gordon and Lintner argue that dividend income has higher value for investors than capital income. Dividends has greater certainty that attract investor. For investor, cash in hand is more valuable than in other wealth so that dividends will affect the stock price. The higher amount of dividends that distributed to shareholder, the higher company's value also.

3. Signaling Theory

Miller and Modigliani (1961) argue that increased in the dividend is a signal to investors that the company's management forecast a good income in the future. Otherwise, dividend decrease is believed to investors as a signal that the company will face tough times in the future. This is contrary to the trend that announcement of dividend increase will improve the stock price, the opposite announcement of dividend decrease will reduce the stock price. It means that managers use dividends as a signal future prospect of firm's earnings. Dividends tend to give an overview of the past rather than the future (Benartzi et al, 1997).

4. Clientele Effect Theory

Baker and Wurgler's catering theory (2004) argue that firms cater to the time-varying dividend demand of investors. Lestari (2012) said that firms will pay dividend when investors put a premium on dividends paying shares. Thus, this theory states that each shareholder will have different preferences on dividend policy. Shareholders who need income is more attracted to dividend payout ratio (DPR). Instead shareholders who did not need income is attracted to retained earnings.

5. Residual Theory

According to Rosdini (2009), this theory explain that company pay dividend only when there is an excess funds on company profit after finance their projects. Basis of this policy is investors prefer to hold and reinvest earnings rather than distribute them in the form of dividends. Profits are reinvested will generate a higher return than the average return that can be generated from the other investments with comparable risk.

6. Agency Theory

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.

2.2.3 Dividend Payout Ratio (DPR)

Dividend Payout ratio is a ratio between dividend paid to net income and usually presented in the form of a percentage. Dividend Payout Ratio determined by the company and will paid to shareholders. Determination of Dividend Payout Ratio is based on the profit after tax (Rosdini, 2009). Dividend is shareholders' rights (common stock) to get company's profit. If the company decides to split the profits in the form of dividends, all shareholders get the same rights. The distribution of dividends to common stock may be made if the company has paid dividends for preferred stock (Jogiyanto HM, 1998). Ang (2000) explain that the dividend payout ratio is the ratio between dividend per share to earnings per share.

When dividend payout ratio decrease, company profit also decrease. As a result, bad signal will appear as indication there is lack of company fund. This condition will cause a stock investor preferences will decrease because investors have strong preferences on dividends. So, the company will always strive to maintain a dividend payout ratio despite decrease the amount of income earned. DPR is a signal for investors who expect to benefit in the form of dividends.

2.2.4 Steps of Dividend Payment

Steps or procedures for dividend payment refers to dividend announcement issuers that will be paid to shareholders who are also called the dividend announcement. The details of the dates that need to be considered in dividend payments is as follows:

a. Declaration date

Declaration date is the date which was officially announced by the issuer on the shape and size of the dividend payment and the schedule will be made. This announcement is usually for regular dividends. The contents of the Declaration about the things that are important are: the record date, payment date, the amount of cash dividends per share.

b. Date of record

On this date the company shall record the names of shareholders. Shareholders registered in the register of shareholders are given the right, while the shareholders registered on the record date are not entitled to receive dividends.

c. Cum-dividend date

This date is the date of the last day of trading stock that is still attached to the right to receive a dividend either in cash or stock dividends dividends.

d. Ex-dividend date

Date that the stock trading is no longer attached to it to obtain dividend. If investors buy the stock on this date or later, then the investor are unable to register his name to get the dividend.

e. **Payment date**

This is the date when payment of dividends by companies to shareholders who have the right to dividends. So, on that date the investor is able to take the dividend in accordance with the form of dividend declared by the issuer.

2.3 Cash Flow Theory

2.3.1 Definition of Cash Flow

Cash flow is a source of internal funds beside profit. This cash flow is cash receipts or expenditures obtained through three types of activities, that is: cash flow from operating activities, cash flows from investing activities, and financing activities. Cash flows from operating activities is an important concern because in the long run company should generate positive cash flow as a measure of liquidity. Positive cash flow (surplus) will increase the availability of funds for investment activities such as purchasing assets, the cost of maintenance / development, and to financing activities such as loan repayments, cash payments to shareholders, and so on (Bernardi, 2010). The greater amount of positive cash flow that generated will result in more liquid and large internal funds. This condition will affect the company's assessment of the company performance.

2.3.2 Definitions of Free Cash Flow

Free Cash Flow describes the level of company financial flexibility. Jensen (1986) defines free cash flow as cash left over after all projects generate positive net present value. Companies with excess free cash flow will have a

better performance than other firms because they can take advantage of various opportunities that may not be obtained any other company. Companies with high free cash flow more predictable survive in a bad situation. When free cash flow is available, the manager allegedly going to waste the free cash flow resulting in inefficiencies in the company. Manager might invest the free cash flow with a small return also.

White et al (1998) defines free cash flow as cash flow available for discretionary companies. Free cash Flow is cash from operating activities minus capital expenditures spent on the company to meet current production capacity. free cash flow can be used for discretionary uses such acquisitions and capital expenditure growth orientation (growth-oriented), debt payment, and payments to shareholders in the form of dividends. The greater of the free cash flow available in company, the more healthy because the company has cash available for growth, debt repayments and dividend. The free cash flow hypothesis is primarily based on the argument that there is a conflict of interest between managers and shareholders. That is, rather than act in shareholders' best interests, managers could allocate the firm's resources to benefit themselves (Jensen and Meckling, 1976). Grullon et all provide some support for the free cash flow hypothesis of Jensen(1986). Dividend-increasing firms maintain their current level of capital expenditures in the future while the level of cash and short-term investments on their balance sheet declines. When they combined with the evidence on declining return on assets, are consistent with firms increasingtheir cash payouts in

anticipation of a declining investment opportunity set as predicted by the free cash flow hypothesis.

Thanatawee (2011) explain an implication of the free cash flow hypothesis is that cash-rich firms that are mature with scarce investment opportunities tend to have overinvestment problem. Thus, a dividend increase announcement by these firms should be accompanied with a positive stock market reaction since it is a signal to shareholders that management will not wastefully use corporate cash flows.

Lang and Litzenberger (1989) in Thanatawee (2011) test the free cash flow hypothesis. Use Tobin's Q ratio, they determine the group of overinvesting firms. Particularly, the Tobin's Q less than one implies overinvestment problem while the Tobin's Q more than one indicate that a firm is undertaking the value-maximising level of investment. The finding in the average announcement return of large dividend change is significantly higher for firms with low Tobin's Q than for firms with high Tobin's Q. It is consistent with the free cash flow hypothesis that dividend increases by overinvesting firms signal management's intention to mitigate overinvestment problem, thereby causing larger stock market reaction.

Meanwhile, according to Rosdini (2009)), free cash flow is cash that can be distributed to creditors or shareholders who are not used to working capital or investment in fixed assets. Free cash flow shows that dividends distributed are not merely a strategy to increasing the value of the company. Various conditions can affect the value of the company's free cash flow, for example, if the company has a higher of free cash flow with a lower of growth rate it supposed to be

distributed to shareholders, but if the company has a higher of free cash flow and growth rate this can be held temporarily and can be used for investment in the coming period. There are several formula to calculate company free cash flow:

1. $FCF = EBIT(1 - \text{Tax Rate}) + \text{Depreciation \& Amortization} - \text{Change in Net Working Capital} - \text{Capital Expenditure}$

If it is discounted after-tax operating income at the cost of capital to value a firm, assumed there is no reinvestment. The depreciation is reinvested back into the firm to maintain existing assets, and it can be assumed an infinite life but no growth (Damadoran and Aswath).

2. $FCF = \text{Cash from Operations} - \text{capital expenditures}$

This represents the financial flexibility of the company; that is, these funds represent the ability to take advantage of investment opportunities beyond the planned investment and how much cash a company has after paying its bills for ongoing activities and growth (McClure, 2010).

3. $FCF = \frac{\text{Net Profit After Tax} - \text{Dividend} + \text{Depreciation Expenses}}{\text{Total Assets}}$

Free cash flow (FCF) can be simply translated as idle cash, the remaining cash after being used for a variety of purposes planned project companies, such as: pay off debt, pay dividends, make investments, etc. The value of a company's operations will depend on all the expected free cash flow in the future, which is defined as operating profit after taxes minus the amount of investments in working capital and fixed assets needed to maintain the business (Handoko, 2008). Thus, free cash flow will reflect a truly cash

available for distribution to investors. Therefore, one of the ways for managers to make the company more valuable is to increase free cash flow

2.4 Life Cycle Theory

Dividends tend to be paid by mature, established firms, plausibly reflecting a financial life cycle in which young firms face relatively abundant investment opportunities with limited resources so that retention dominates distribution, whereas mature firms are better candidates to pay dividends because they have higher profitability and fewer attractive investment opportunities (DeAngelo *et al*, 2004). Modigliani and Miller (1961) in Lestari (2012) argue for dividend irrelevancy under the perfect market assumption. Relaxing those assumptions leads us to signaling, clientele, agency-based life cycle and more recently behavioral-based catering theory of dividend. Yet, the decision to pay or not to pay dividend remains an empirical questions. So far, research results shows that signaling, clientele, and catering theory are not empirically supported. Empirical research tends to lend support to agency-based life cycle theory (DeAngelo *et al*, 2004).

Fama and French (2001) find that U.S. firms paying dividends are significantly larger, more profitable and have fewer growth options than firms that do not pay dividends. They argue that changes in firm characteristics do not fully explain the decline in dividend payers over recent years.

According DeAngelo et al (2006), 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) and falls to near zero when most equity is contributed rather than earned. In a broad set of multivariate logit tests, we consistently observe a highly significant relation between the decision to pay dividends and RE/TE (and RE/TA), controlling for firm size, current and recent profitability, growth, total equity, cash balances, and dividend history, a relation that also holds for dividend initiations and omissions. They also show that the proportion of a firm's retained earnings to total assets is positively associated with the probability of paying a dividend. This is consistent with the firm relying more on earned rather than contributed equity, and more likely to occur as firms mature and reach a steady state of profitability. They argue that this is not consistent with the theory that dividends signal future profitability. Firms with low retained earnings would be ideal candidates for signaling, but it is the large, currently profitable firms with less growth options that tend to pay dividends.

Grullon et al in 2007 suggest that increases in dividends convey information about changes in a firm's life cycle, specifically, as to a firm's transition from a higher growth phase to a lower growth phase, which we refer to as a mature phase. As firms become more mature, their investment opportunity set becomes smaller.

2.5 Dividen Policy Usefulness for Investor Decision

Using dividends as a sign that the announcement stating that company has decided to increase the dividend per share might be interpreted by investors as a

good signal, because higher dividend per share shows that company is confident with the future and cash flow will be large enough to bear the level high dividends (Weston and Copeland, 1995).

Investors desperately need information relating to the company. One of that information is information about the dividend policy. According to Miller and Rock (1985) in Gantowati and Sulistiyani (2008), the announcement of dividend changes can be the basis for investors to determine the firms earnings and the expected future earnings. Therefore, companies that go public have to report its performance to investors in the financial statements and the amount of dividend announcements.

Sujoko (1999) tested dividend announcement during 1994-1996 using market adjusted models, mean adjusted and market model to calculate abnormal returns. The result is the day before the announcement, the announcement day and the day after the announcement of dividend increases, there is a positive market reaction. Setiawan and Hartono (2003) proved that the investor on the JSE (Jakarta Stock Exchange) reacts to the announcement of dividends quickly, so the abnormal return enjoyed by investors occurs during the announcement. It means that dividend announcement by the company contains information that will be useful for investors.

2.6 Dividend Regulation in Indonesia

Indonesian Corporate Act regulate company's dividend payment. The 2007 Corporate Act placed a restriction on dividend payment with regards to retained

earnings, paid in capital and net assets. The content of regulation reflected in Indonesia Corporate Act article 70 to 72, as follow:

1. Article 70

(1) Companies shall set aside a certain amount of the net profits each financial year as a reserve.

(2) The mandatory setting aside as a reserve as contemplated in paragraph (1) applies if the Company has a positive balance of profits.

(3) Net profits shall be set aside as contemplated in paragraph (1) until the reserve reaches at least 20% (twenty per cent) of the total subscribed and paid up capital.

(4) The reserves contemplated in paragraph (3) [sic] which have not yet reached the amount contemplated in paragraph (2) [sic] may only be used to cover losses which cannot be met by other reserves.

2. Article 71

(1) The use of net profits including the determination of the amount to be set aside for reserves as contemplated in Article 70 paragraph (1) shall be decided by the GMS.

(2) All net profits after the deduction to be set aside as reserves as contemplated in Article 70 paragraph (1) shall be allocated to the shareholders as dividends unless determined otherwise in the GMS.

(3) The dividends contemplated in paragraph (2) may only be allocated if the Company has a positive balance of profits.

3. Article 72

(1) Companies may allocate interim dividends before the Company's financial year ends provided the Company's articles of association so provide.

(2) Interim dividends may be allocated as contemplated in paragraph (1) if the Company's total net assets do not become less than the total subscribed and paid up capital plus the mandatory reserve.

(3) The allocation of interim dividends as contemplated in paragraph (2) may not disrupt or cause the Company to be unable to fulfil its obligations to creditors or disrupt the Company's activities.

(4) The allocation of interim dividends shall be determined by a resolution of the Board of Directors after obtaining the consent of the Board of Commissioners with due attention to the provisions of paragraphs (2) and (3).

(5) In the event that after the financial year ends it transpires that the Company has suffered losses, the interim dividends allocated must be returned to the Company by the shareholders.

(6) The Board of Directors and Board of Commissioners shall be jointly and severally responsible for the Company's losses in the event that the shareholders do not return the interim dividends as contemplated in paragraph (5).

2.7 Hypothesis Development

2.7.1 The Impact of FCF / TA to Dividend Policy

Company's policy to distribute dividends and its amount depend on the company's cash position. When the company can earn high profits while the cash position seems not in a good situation, the company may not pay dividends. If the company requires substantial funds to finance investment or the company is still growing, most of their funds are embedded in fixed assets and working capital. Therefore, the ability to pay dividends is very limited. Dividends are cash outflows so that the stronger company's cash position will influence the company's ability to pay dividends. Excess cash that available for shareholders is free cash flow.

According to Jensen (1986), free cash flow is cash which remains after all projects generate positive net present value. Meanwhile, according to Ross et al. (2000) in Rosdini (2009), free cash flow is cash that can be distributed to the company's creditors or shareholders who are not used to working capital or investment in fixed assets. Conflicts of interest between shareholders and managers over dividend policies are very severe when the company generates substantial free cash flow. When the free cash flow is available, the manager allegedly is going to waste the free cash flow resulting inefficiencies in company or to invest free cash flow with a small return (Smith & Kim, 1994). To mitigate that interest differentiation, company will pay free cash flow to shareholders as dividend. This payment will create positive relationships between free cash flow and company's policy to pay dividend. On the other side, if the company doesn't

pay dividend, it will create negative relation between free cash flow and company's policy to pay dividend (Thanatawee, 2011). This is consistent with Rosdini (2009) who found free cash flow positively affecting dividend payout ratio (DPR) and Thanatawee (2011) who explained that larger and more profitable firms with higher free cash flows and retained earnings to equity tend to pay higher dividends. Thus the hypothesis is arranged as follows:

H1: Free cash flow as proxied by FCF/TA positively affect dividend policy.

2.7.2 The Impact of RE / TE to Dividend Policy.

The history of company profitability can be displayed from the retained earnings. The company in growth stage usually pays lower dividend because they also have lower retained earnings. This situation is the opposite of the company in mature stage who have higher retained earning because they usually accumulate more profit, ever since they still became a younger company. Based on De Angelo et al (2006), firms with lower retained earnings as a proportion of total equity (RE/TE) tend to be in capital infusion stage. On the other hands, firms with higher RE/TE tend to be more mature with ample cumulative profits. They can do largely financing by their self, hence they will be a good candidate to pay dividend. RE/TE measures the life cycle stage of firms as the extent to which that firm's equity is earned or contributed, in other words it measures the extent to which the firm is self-financing or reliant on external capital.

Research by Lestari (2012) proves that dividends are paid by bigger and more mature firms casts doubt to the signaling hypotheses but providing support

to agency-based life cycle theory. Other research by De Angelo et al (2006) also said a firm will pay high dividends when retained earnings are a large portion of total equity (and of total assets). Thus the hypothesis is described as follows:

H2: Company's life cycle as proxied by RE/TE positively affect dividend policy.

