CHAPTER 1
INTRODUCTION

1.1. Background

All firms that specialize within the capital market should be aware of what is called as investments. An investment is the purchase of securities with a chance of receiving a payoff in term of future cash payments (dividends) and receiving capital gain by virtue of them being based on something of increasing value. In contrast, a speculation is when someone seeks to buy and sell in order to take advantage of market price fluctuations. Alternatively, an investor is someone who buy things because analysis confirms that the investment is of high quality and worth holding, while a speculator is someone who buys only because they believe someone else will pay more for it in the near future. Nevertheless, it is actually similar with an investment since it also needs speculation acts. An investment is divided into two types, which are financial investment and non-financial investments.

A financial investment itself is dividend into two, which are the investments in the money market and the capital market. Investments that is considered as a money market investment is when dealing with things such as deposits, while investments in the capital market is when they are dealing with equity / stocks and fixed incomes / obligations with all of its derivative form. A non-financial investment is the investments of goods such as properties, etc. It can also be looked by its nature like direct and indirect form.

Through various reports which are given from the company to the shareholders, an *annual report* is the most important reports. There are two types of information contained in annual reports. The first one is the non-financial information, which is the information that describes the company's operation in the previous year and explains plans and strategies that affect operations in the future. The second one is financial information that explains the financial performance and financial positions of the firm. This financial information takes the forms of balance sheet, income statement, cash flow statement, equity statement and notes to the financial statement. These reports give picture regarding the operation of the company from financial perspectives. These reports are used by investors in formulating economic decisions regarding investment or divestment in the company. These reports are also used to determine the risk of investing in the company that translates into required earnings and dividend levels by investors.

Those verbal information and quantitative of the financial report have an important role because it gives a brief report on what is really happening to the assets, revenues, and dividend for the several years before, while verbal report explains about the reason why it is done.

A company's performance can be evaluated by using many variables and indicators. The main consideration in this problem is the financial report because some of the financial ratios can be executed to know the company's performance. Financial ratios were specifically made to compare the strengths and weaknesses of a company to the others in the same industry, and also show whether the financial position is in an increasing or decreasing performance for a period of time. There is also an advantage could be taken in consideration for using this kind of ratio, which are (Foster 1986): (a) to control the effects from the size difference between corporations for a period of time. (b) to make it easy in using the statistic tools, i.e. regression analysis. (c) to prove the theory where ratios were an important variable. (d) to exploit an empiric research between financial ratio and estimation or prediction from the important variables (risks from the securities or the company's tendency of a bankruptcy). In other words, Foster (1986) announced that the purpose of this ratio analysis in reflecting the company's performance is mainly to make an estimation counting of future variables, such as revenues, expenses, profits, dividends, and capital structure.

A stock is divided into two and that is a preference stock and a common stock. These two kinds of stock are the types that an investor can buy from the *equity securities* in the capital market. An alternative investment besides the *capital market securities* (fixed income and equity securities) to investors are *non-marketable assets*, *money market instrument*, and *derivative securities*. Meanwhile, most of the times investing are defined as a commitment that is planted in an asset or more which is going to be held in some period of time in the future. Investing was mostly done to increase the investor's wealth mainly in the financial sector for the current and future time.

There are two kinds of *security return*, which is dividend and capital gain. A dividend payment is measured on a *dividend payout ratio*. The basic value related to dividends is a *dividend yield* that's measured from dividend/stock divided with closing price of the related period, and dividend payout can be in a form of cash dividend and stock dividend. Meanwhile *capital gain* is the difference between buying and selling price in the capital market.

Dividend can be measured as a company's sacrifice in the term of cash payment which announced by the board leader and paid annually to the stockholder. A common stock has substantial risks because dividend has a tendency to fluctuate, thus investor's expectation can increase or decrease in a short period of time. Foster (1986) stated that the purpose of this financial ratio analysis could reflect the company's performance primarily to make an estimation in the variables probable to occur in the future such as *revenue, expense, profit, dividend, and capital structure.*

A company's decision regarding dividend are sometimes being integrated by the decision of funding and investation. The more complex the company's workload, the more conflict between stockholders and management. There are to much factors that has to be considerd regarding a company's dividend policy. Within those factors, it is difficult to decide on which policy that will be the most dominant in affecting a company's cash dividend. Several previous researches mentioned, in general, that the affecting factors are profitability, liquidity, capital structure, leverage, ownership, etc. While this research only took three out of the many factors, which are profitability, liquidity, and capital structure.

A Liquidity ratio is to measure the availability of cash to pay debt. There are two kinds of liquidity ratio, which are to count Current ratio and Acid-test ratio

(Quick ratio). To know a Current ratio is by dividing current asset to current liabilities, and (current asset – inventories) / current liabilities for the Acid-test ratio.

The Profitability ratio is to measure the firm's use of its assets and control of its expenses to generate an acceptable rate of return. Profitability itself comes from the word profit where its definition is the equality of total revenues and total costs. This term then match the rate of return that is the minimum rate required in maintaining the present level of investment. Thus, it is treated as cost, and recognized as the two components of cost of capital.

The Capital structure of a company has several definitions, which are:

- the particular combination of debt, equity, and other sources of finance which is used to fund the company's long term financing.
- A mix of company's long-term debt, specific short-term debt, common equity and preferred equity.
- The way a firm finances its overall operations and growth by using different sources of funds.

The proportion of long-term and short-term debt here is considered when analyzing the capital structure. It is most likely that people are referring to a firm's debt-to-equity ratio when they are referring to a company's capital structure.

This research limits the scope of factors that is considered to have effects towards dividend payout ratio into three, which are liquidity, profitability, and capital structure. The samples in this research are taken from the companies which are listed in the Jakarta Stock Exchange (BEJ). The time period taken in this research object are the period that ends June 2006. the purposive sampling in this research are the companies that moves in all sectors except financial industry and others, the companies that have give out dividend for a continuosly period and also have enough data needed in this research.

Thus, this paper aims to explain the factors involved behind the variability of dividend payout ratio across the companies listed in the Indonesian Capital Market Directory Book 2006. This study will also determine how the dividend payout ratio will be affected by those factors. The effects from these three factors and the dividend payout ratio will be determined using multiple regression analysis. Following all the brief explanations given above, this paper, therefore, is entitled:

Factors that affect the Dividend Payout Ratio: A Study of Companies Listed in the Indonesian Capital Market Directory 2006, for the period of 2003 – 2005.

1.2. Problem Identification

1. How is the effect of the level of profitability ratio to the dividend payout ratio?
2. How is the effect of the level of liquidity ratio to the dividend payout ratio?
3. How is the effect of the level capital structure to the dividend payout ratio?

1.3. Scope of Analysis

This study purpose is to analyze the dividend payout across companies listed in the Indonesian Capital Market Directory Book 2006, which fulfil their obligation to their stockholder by paying the dividend continually during 2003-2005. The analysis will include all of the companies except companies in the financing sector.

1.4. Aims and Benefits

The **objectives** of this study include :

1. To identify the effect of profitable ratio to the dividend payout ratio.
2. To identify the effect of liquidity ratio to the dividend payout ratio
3. To identify the effect of capital structure to the dividend payout ratio

The **benefits** of this study, could be describe from several perspectives :

a. <u>The Company's perspective</u>

The payout ratio will figure out what percentage of the company's earnings are being paid out in the form of dividends. Generally a payout ratio of 60 percent and lower is considered very safe. Therefore to get a healthy dividend payout ratio, the company should always keep their earning higher than the dividends the company pays out.

b. <u>The Investor's perpective</u>

In purpose of investing, the investors will get an important information about what to do before they decide to invest in certain stock. They must check the wealth management of the company who release the stock.

c. The Researcher's perspective

With the result of this study may stimulate other researchers to do the same study to get more clarification of this matter.

1.5. Hypothesis

The research question in this study is that what factors affects dividend payout ratio of the public firms in Indonesia. That research question is translated into three hypotheses as follow:

1.5.1. H0 : Profitability has no positive effect towards dividend payout ratio

H1 : Profitability has a positive effect towards dividend payout ratio

1.5.2. H0 : Liquidity has no positive effect towards dividend payout ratio

H1 : Liquidity has a positive effect towards dividend payout ratio

1.5.3. H0 : Capital structure has no positive effect towards the dividend payout ratio

H1 : Capital structure has negative effect towards the dividend payout ratio

1.6. Research Methodology

In completing this thesis, the type of method used by the author is literature survey and empirical study through analysis of secondary data by gathering the information or data that are relevant to the topic. The test that has been done for this research is using a regression analysis, in the effort to know how the independent variables could affect the dependent variable.

It is applied for the documentation of a comprehensive review of the published works from the secondary sources in the areas of Indonesia's capital market. The resources of information or data gathered derive from books, internet, official data obtained from the Jakarta Stock Exchange (BEJ), and magazines.

The statistic model for hypothesis testing used in this research is :

$$\mathbf{DPR_i = \alpha + \beta_1 P_i + \beta_2 L_i + \beta_3 CS_i + \varepsilon_i}$$

- DPR = Dividend Payout Ratio
- P = Profitability
- L = Liquidity
- CS = Capital Structure
- ε_i = Disturbance Error

The *dependent variable* is the dividend payout ratio which uses the proxy DPR, the formula for this variable is:

$$\mathbf{DPR = \frac{Total\ Dividend\ Per\ Share}{Earning\ Per\ Share} \times 100}$$

The *independent variables* in this research is consisted into profitability, liquidity, and capital structure.

- The profitability ratio uses the proxy ROA. The formula for profitability is:

$$ROA = \frac{\text{Net Profit}}{\text{Total Asset}} \times 100$$

- The liquidity, it uses the proxy current ratio which have the formula of :

$$CR = \frac{\text{Total Current Asset}}{\text{Total Current Liabilities}} \times 100$$

- The capital structure uses the formula :

$$CS = \frac{\text{Long Term Liabilities}}{\text{(Shareholder's Equity +Long Term Liabilities)}} \times 100$$

1.7. Thesis Structure

This thesis is divided into five chapters in which each chapter has different content and explanation of the topic relating with one to another:

Chapter 1 Introduction

This chapter discusses several fundamental points of making the thesis. It defines the research background, scope of analysis, aims and benefits, research methodology, and followed with the thesis structure. For the background, the author describes about what is annual report, financial report, stocks, and security returns. The scope of analysis defines the scope problem and all that constraints the problem. While aims and benefit gives an explanation of what the author wants to find out from doing this research and the possible benefits for the people involved. For the research methodology section, it describes the methodology of gathering the information in terms to help author in completing the thesis.

Chapter 2 Theoretical Foundation

In chapter 2, the author explains about the theoretical foundation regarding the topic of the thesis. This chapter summarizes the relevant theories according to the problem. The resources are obtained from the data stored in the Indonesian Capital Market Directory Book in terms with the relationship between dividend payout and the factors involved.

Chapter 3 Research Methodology

Chapter 3 will discuss about the author's aim in doing this research. It will also thoroughly discuss about the hypotheses have been made, what are the samples the author took, its design, and the method used to prove the hypotheses. Not to forget, how it will be interpreted and by which tool the author will be using.

Chapter 4 Findings & Discussion

Chapter 4 is describing the attempts that have been done by author prove the findings in a detailed information. Thereafter, the author will discuss on the findings and propose some kind of solutions to aid the situation in order to create a balance in the industry and market.

Chapter 5 Conclusion and Recommendations

This chapter contains the conclusions and recommendations of completing the research. The author will make conclusions from the result of implementing the solutions as well summarizing what is important the author gets within the findings. Also, the author will draw some recommendations and advises which is possible to take in considerations in order to achieve a better solve for the problems occur.

Appendices

This section contains Tables of coding result

References

This section consists of the sources used in this study