CHAPTER 2
THEORETICAL FRAMEWORK

2.1 Dividend

Companies receive capital (long-term funds) in the form of debt or equity. Funding through debt means the company borrowed the funds, while funding through equity means the company receives investment from the owners by issuing shares or holding retained earnings (Mutumanikam & Erliani, 2014).

If the company issues a stock, the buyer becomes shareholder or stockholder. This means that the certificate holder shares the company's equity, no matter how small. Company can issue either common stock or preferred shares. Common stock is securities that indicate a partial ownership of a particular company. Preferred shares are securities that show partial ownership of a particular company and offer certain priorities over common stock (Mutumanikam & Erliani, 2014).

The shareholder will receive some special treatment, one of them is they receive dividends. Dividends are part of company's profits paid to the shareholders, which are usually distributed in the form of cash (Ross, Westerfield, and Jordan, 2010:547). Weygandt, Kimmel, and Kieso (2012) state that dividend is a division of net income generated by the company to the shareholder proportionally. Meanwhile, dividend by Darmadji, Tjiptono and Fakhrudin (2012:140) is the division of the remaining net income generated by the company which will be distributed to the shareholders with the approval from General Meeting of Shareholders (GMS). From the above statement, it can be concluded that dividend is part of the net profit of the company that distributed to the shareholders according to their ownership proportion of certain capital that has been approved by General Meeting of Shareholders (GMS).

The dividend policy is a firm's decision to determine how many dividends that should be distributed to shareholders (Gitman & Zutter, 2014). This policy stems from how the management treatment of profit or profit that generally, half of the net income after tax is distributed in the form of dividend and the rest of it are reinvested into the company in the form of retained earnings. Retained earnings are one of the most important sources of fund to finance corporate

growth, while dividends are cash flows paid to the investors from the company's net income.

2.1.1 Form of Dividend Distribution

The dividend can be shared within some form that in accordance with company policy. According to Kieso, Weygandt, and Warfield (2014) there are four types of dividends:

1. *Cash Dividends*

   Cash dividend is distributed dividend in the form of cash. Cash dividend payments will reduce cash and retained earnings of the company.

2. *Property Dividends*

   Property dividend is the dividend distributed to the shareholders in the form of assets other than cash held by the company. The examples of assets other than cash that can be distributed to shareholders are merchandise, share of other company owned by the company, and others.

3. *Liquidating Dividends*

   Liquidating dividend is distributed dividend to shareholders as a result of the liquidation of the company. Payment of this dividend is based on the reduction of the company's capital. It does not base on profit generated by the company. A dividend declared out of share capital or share premium is referred to as liquidating dividends.

4. *Stock Dividends*

   Stock dividend is the distributed dividend to the shareholders in the form of company's shares, resulting in the number of company's shares is increasing. However, the company's cash flow is not disturbed because the company does not need to spend cash.

2.1.2 Types of Dividend Policy

The dividend policies taken by companies vary, depending on the board's decision at the shareholder's general meeting. There are three types of dividend policy according to Gitman and Zutter (2014:630), such as:

1. *Constant payout ratio dividend policy*

   The dividend payout ratio shows the percentage of each dollar obtained which are distributed to the owner in cash.

The calculation is done by dividing the dividend per share with earnings per share. With constant payout ratio dividend policy, the company sets a certain percentage of its revenue paid to the owner in each dividend period. Existing problems on this type of policy is if the company's revenue falls or if losses occur in the specified period, the dividend may become low or even none. The condition and status of the company to come often be the indicator considered in determining the dividend can negatively affect the stock price of the company.

2. *Regular dividend policy*

   This policy is based on payment of fixed dollar dividend within every period. Companies that use this policy often increase the regular dividend in case of any sustainable increase on earnings and generally under this dividend policy almost never experience decrease.

3. *Low regular and extra dividend policy*

   This policy is based on regular low-pay dividend payments, plus with an extra dividend when earnings are higher than normal at the specified period. The company avoids expectation that an increase in a permanent dividend by calling an additional dividend as extra dividends. By setting a low regular dividend, the company giving investors a stable income that is useful to build confidence in the company, and extra dividends allows them to share revenue especially in the good period. Companies that use this dividend should improve regular dividends as revenue increases. Extra dividends do not have to be routinely distributed.

2.1.3 Procedure of Dividend Distribution

In the dividend payout, the company will announce officially the schedule of the dividend payments either by cash dividends or stock dividends. According to Gitman and Zutter (2014:619), there are three important dates related to dividends:

1. *Date of record*

   The date of record is the date on which the company prepares a list of shareholder's names whose are entitled to a dividend.

2. *Ex-dividend date*

Ex-dividend date is the date on which the company ensures that dividends will be distributed to the right people. If an investor buys the stock 2 days before the date of record, then he is entitled to the dividend. Meanwhile, if an investor buys the stock after the date of the record, then the previous owner is entitled to the dividend.

3. *Payment date*

   The payment date is the date on which a check of dividend payment is sent to the rightful shareholders.

2.1.4 Factors that Affect Dividend Policy

The company's dividend policy describes the plan for action that will be followed whenever decisions on dividends have been made. Factors that become consideration in setting dividend policy according to Gitman and Zutter (2014:628) includes:

1. *Legal Constraints*

   Most states prohibit companies from paying cash dividend. It is calculated with par value of common stock. Other countries set legal capital to not only include par value of common stock, but also paid-in capital in excess of par. Companies sometimes set requirements to limit the amount of dividend. With this limitation, the company cannot pay cash dividends more than the total of its retained earnings. In other words, dividends may only be paid from past and present earnings and may not be if their payment will lead to loss or insolvency for the company.

2. *Contractual Constraints*

   The company's ability to pay cash dividend is often limited by a very strict provisions of the debt agreement. Generally, these limitations prohibit the payment of cash dividends until the company has reached a certain level of income, or they can limit the dividend on a certain dollar amount or a percentage of revenue. The limitation of dividend helps protect creditors from losses due to the company's inability to pay.

3. *Growth Prospects*

   The company's financial needs are directly related to growth expectations and asset acquisition. Companies are expected to evaluate the profitability and risk to develop insight about the ability to increase the external capital.

Companies should determine cost and speed to obtain financing. Generally, large companies have adequate access to new capital, while a fast-growing company may not have the fund which is sufficient to support an approved project. A developing company is heavily dependent on internal funding through retained earnings, so they share a smaller dividend.

4. *Owner Considerations*

This factor may be either to pay dividends at the end of each trading period or reinvest so as to be able to grow the organization. Companies must establish policies that affect both the wealth of the majority of its owners. One consideration is the tax status of the company's owner. If the majority of owners are rich shareholders with considerable income, the company can decide to pay a lower percentage of their earnings, so the owner can defer payment of taxes until the shares have been sold. Shareholders who have lower income that needs dividend income will prefer higher payment on revenue.

Another thing to consider is the owner's investment opportunity. If owners have better external opportunity, companies should pay a higher percentage on its income. The last consideration is dilution of potential ownership. If the company pays higher percentage than its earnings, new equity capital must be raised with common stock. The results of issuing new shares can weaken the control and income for owners.

5. *Market Considerations*

One of the most recent theories that explain the decision of company's policy is catering theory. According to this theory, the investor's demands on dividends fluctuate from time to time. As the economy is in recession and the stock market falls, investor will prefer dividends. Catering theory shows that more companies tend to start paying dividends or to increase the payouts that exist when the investor shows a strong preference of dividend.

2.1.5 Theoretical Framework

According to Heinen (1985), theory is a group of logically organized laws or relationship that constitutes explanation in a discipline.

The underlying theory in this research will be explained as follows:

1. *Dividend Signaling Theory or Informational Content*

According to this theory which was suggested by Michael Spence in 1973, if the company announces a higher dividend rather than anticipated or expected markets, this would be interpreted as a signal to the investors that the company has a brighter future for financial performance than expected. Given such a good signal, investors will buy the stock of the company so the stock price increases. Conversely, if the company announces a lower dividend than expected then this would be interpreted as a bad signal. Miller and Modigliani state that a decrease in dividend could indicate that future earnings of the company will be disappointing. It will cause a decline in company's stock prices (Gitman & Zutter, 2014).

2. *Residual Theory of Dividends*

   The Residual Theory of Dividends states that dividend will be paid if the company has residual net income after meeting the funding needed for a profitable investment for the company (Gitman & Zutter, 2014). Based on this theory, the company's policy to pay dividends is the last priority if the company has residual funds. If the company revenue in that year is not sufficient for the company's funding, then the dividends will not be paid by the company. In other words, this theory assumes that the company's main funding comes from its retained earnings.

3. *Pecking Order Theory of Dividends*

   The Pecking Order Theory of Dividends is one of several theories related to the capital structure of the company. This theory was suggested by Donaldson (1984) which was later refined by Myers and Majluf (1984). The Pecking Order Theory of Dividends describes a level in corporate fundraising which indicates that companies prefer to use internal equity in financing investments and implement them as growth opportunities. This theory states that companies prefer internal funding rather than external funding, secure debt rather than risky debt, and ordinary shares (Myers & Majluf, 1984).

   The company will choose to fund based on the order of preference, starts from prioritizing a non-risk funding, minimal risk to high risk. First, the company will seek to obtain a non-risk fund. If non-risk funding cannot be obtained, then the company will choose a fund with smaller risk. And if small-risk funding cannot be obtained, the company's final step is to seek funding that has higher risk.

Retained earnings are the first option that a company chooses because it is not a risk or has the least risk among other funding options. Retained earnings are internal funding derived from operating profit of a company in the previous period. If the retained earnings are not sufficient, the second option is with external funding, i.e. debt. If debt cannot be obtained, then the last option is funding from equity or issuance of new shares. Shareholders judge that issuing new shares is riskier than debt.

The investment financing is decided by using internal funding which is by using preferred company's retained earnings compared with external expenses because the costs incurred will be cheaper. Therefore, the company tends to finance its investment projects by using retained earnings. Thus, as long as there is still investment that can be financed then the dividends paid will be lesser depend on the available residual internal funds. In this theory, companies that are experiencing high growth will make fewer dividend payments compared to the company who has lower growth rate.

4. *Agency Cost of Free Cash Flow Theory*

The agency theory is developed by Jensen and Meckling (1976). This theory explains that the interests of managers and the interests of shareholders are often contradictory, so it can cause a conflict between them (Keown, Martin & Petty, 2008:422). The situation happens because managers try to put his personal interests that are not in accordance with the investor interests as priority where the manager's interests can augment the company's expenses that can reduce the company's profit. These conflicts can be reduced by the presence of a mechanism so that it can align with those interests. Monitoring mechanism caused the occurrence of agency costs.

In theory of free cash flow, it explains that the distribution of dividend to investor becomes a means to reduce agency costs in free cash flow (Jensen, 1986). With the distribution of dividend to shareholders, it caused unavailability of free cash flow for the company, so management is forced to seek external funding such as issuing new shares to finance its investment. Indirectly, dividend distribution can oversee the company's investment activities, so it can minimize conflict between manager and shareholder.

5. *The Firm Life Cycle Theory of Dividends*

This theory is based on the concept that as a firm becomes mature its ability to generate cash overtakes its ability to find profitable investment opportunities. Eventually, it becomes optimal for the firm to distribute its free cash flow to shareholders in the form of dividends.

2.2 Previous Research

The previous studies used as comparative and reference materials in this research can be seen in Appendix 1.

2.3 Hypothesis Development

Generally, before the investors invest their funds, firstly they will see the company's ability in generating profit. Net income is an important element both for the company and for the investor, because with that profit the company can expand its business and pay dividend to shareholders. Therefore, the level of profitability becomes important consideration for investors before investing.

Investors also need information about the company's ability to pay its liabilities and growth rate. This is important because the profits generated by the company are primarily used to pay its obligations in the form of interest and repayment of its debts. Most of the remaining net income after paying off the debt, can be used to finance the company's growth, pay dividends, and retained earnings.

The other indicators that may affect dividend policy are agency cost and firm size.

2.3.1 The Effect of Profitability on Dividend Payment

The profitability reflects the company's ability to generate net profits when the business is running for a certain period. The level for profitability becomes one of the important factors that influence the company's policy in distributed dividends, because the dividends are part of net income obtained by the company. Therefore, the dividend will be distributed if companies can generate profits.

The company's profitability level can be measured by these profitability ratios, which are Return on Equity (ROE) and Return on Assets (ROA) (Gitman & Zutter, 2014). ROE ratio is used by investors to measure the ability of a company to generate profits from its shareholders investments. The greater the

ROE level indicates the greater the company's ability in generating profits. ROA is a financial ratio that is widely used to measured company's performance, especially concerning the company's ability in generating profit by using its assets. A high rate of ROA indicates a solid financial and operational performance. With the increase in profits, the amount of cash or excess cash owned by the company will increase as well.

One theory that explains the profitability hypothesis is the Dividend Signaling Theory. This theory states that investors consider changes of dividend as a signal to the expected management earnings in the future. These signaling effects need to be considered when the company wants to make changes to dividend policy. Therefore, profitability becomes the independent variables in this research (Gitman & Zutter, 2014).

Meanwhile, according to the Agency Cost of Free Cash Flow Theory, companies who have bigger cash money or large excess cash preferred to distribute dividends in big amounts rather than use those cash for investment activity.

Another theory that is underlying this hypothesis is the Pecking Order Theory of Dividends. This theory states that company prefers to use internal funding rather than external funding. Unlike the profitable company that tends to have more internal generated funds available for reinvestment, less profitable company are forced to gain external financing from capital market by issuing shares. There is a high chance that profitable company will pay higher dividends rather than less profitable company. Therefore, according to these theories profitability has positive effect on dividend payment.

But, if we are looking on the other perspective of the Pecking Order Theory of Dividends and the Dividend Signaling Theory or Informational Content. Profitable companies are usually better in generating retained earnings rather than less profitable companies. They will prefer to use those earnings as a capital or to finance the company's growth and operations. Hence, profitable company will pay fewer dividends. On the other hand, less profitable firms will pay higher amount of dividends to shareholders because they want to attract more investors to invest in the company (Jozwiak, 2015). Therefore, according to this theory profitability has negative effect on dividend payment.

Since the relationship between profitability and dividend payment is conflicting therefore, the first hypothesis is undirectional and stated as follows profitability has significant effect on dividend payment.

H_{01}: Profitability does not significantly affect Dividend Payment

H_{A1}: Profitability significantly affects Dividend Payment

2.3.2 The Effect of Leverage on Dividend Payment

Leverage can be referred to as the amount of debt a firm uses to finance its assets. The leverage ratio can be used to measure the company's ability in settling all its obligations, either short term liabilities or long-term liabilities (Gitman & Zutter, 2014). There are two common ratios to measure the company's leverage level, i.e. Debt Ratio (DAR) and Debt to Equity Ratio (DER). DAR is a ratio used to measures how well a company can pay their liabilities with their assets. The higher the ratio, the greater the amount of debt being used to generate profit. DER is a ratio used to measure a company's financial leverage. This ratio indicates how much debt a company is using to finance its assets relative to the value of shareholder's equity. In other words, this ratio shows the percentage of financing that comes from banks and shareholders. In general, a high DER level indicates that the company may not be able to generate enough cash to pay its debt obligations (Gitman & Zutter, 2014). However, low DER level may also indicate that a company is not taking advantage of the increased profits that financial leverage may bring.

There are four theories that are underlying the leverage hypothesis, i.e. the Pecking Order Theory of Dividends, the Residual Theory of Dividends, the Agency Cost of Free Cash Flow Theory and the Dividend Signaling Theory.

As mentioned before, the Pecking Order Theory of Dividends is a theory which states that company prefer to use their internal funding, which is retained earnings rather than to raise external funding, such as debt and equity issuances. On the other hand, the Residual Theory of Dividends is a theory which states that the dividend will be paid by the company if they have residual funds or net income. According to these theories, it assumes that if the company's internal fund is insufficient to pay the company's debt, the company will seek funding from capital market. Hence, the company will reduce the portion of dividends

that will be distributed to shareholders because the company will prefer to pay off their debt rather than paying dividends.

Meanwhile, in the Agency Cost of Free Cash Flow Theory, it implies that when a company raises money for working capital or capital expenditures by selling debt instruments, it usually provides a control mechanism to monitor and restrict the management from using its free cash flow. A company with high debt level tends to have a higher financial risk. Hence, the company will pay fewer dividends to shareholders in order to ensure its survivability as ongoing concerns.

And the last theory that underlying this theory is the Dividend Signaling Theory. In this theory, the company credibly conveys some information about itself to another party, e.g. investors. If the company's financial leverage is high, it will indicate that the company does not have good prospect on their financial performance. It can also be a signal to the investors that the high debt level company will not have the intention to pay higher dividends.

Aside from these theories, the company's debt policy becomes one of the important considerations for investors before investing. This is due to companies with higher debt levels will use his net profit to pay off all its obligations in the form of interest and debt repayment before paying dividends. Company who has a high debt level will not only become attention for the shareholders, but also a concern for the creditor. The creditor worried the company cannot pay off all the debts.

Therefore, creditors apply debt agreements or debt indenture with the company to protect its interests. One of the contents in the agreement is in the form of a negative covenant which is about restrictions on management policies including the limitation of dividend distribution to shareholders. With the limitation of dividend payout, it will minimize the portion size of distributed dividend.

Therefore, the second hypothesis is leverage has negative effect on dividend payment.

H_{02}: Leverage has no significant negative effect on Dividend Payment

H_{A2}: Leverage has significant negative effect on Dividend Payment

2.3.3 The Effect of Growth on Dividend Payment

Companies that have high growth rate will need bigger funds than the company with lower growth rate. The company's funds are used to finance company growth in investment activities, corporate expansion, and company projects. The funds can come from internal and external sources.

In this research, the growth rate will be measured by Market to Book Ratio. Market to Book Ratio is a ratio that shows the comparison between the stock market value per price of the company's book value obtained from the difference between the value of assets owned by a company and the value of liabilities.

The effect of Market to Book Ratio on shares with a high enough ratio between market value and book value has the ability to calculate stock returns on the book value proxies for future cash flows. And produce a variable related to stock returns, where the basic strategies for trading are used in two combinations, namely income and book value (Bae & Kim, 1998). In addition, the Market to Book Ratio also provides profitability and the results of future stock returns by using a combination of market to book ratio and dividend yield, where the combination can show the performance of future stock returns (Jiang & Lee, 2007).

There are four theories that underlying the growth hypothesis, i.e. the Pecking Order Theory of Dividends, the Agency Cost of Free Cash Flow Theory, the Dividend Signaling Theory and the Residual Theory of Dividends.

The Pecking Order Theory of Dividends which was discovered by Donaldson in 1984, states that firms tend to seek funding at minimal risk. This theory was later refined by Myers and Majluf (1984), according to them, financing comes from three sources, which are debt, internal funds and new equity. Companies prioritize their sources of financing by firstly preferred to use internal financing when that is depleted and then debt is issued, lastly raising equity. There is no optimal capital structure in this theory because the selection of corporate funding is based on the order of risk preference (hierarchy). Meanwhile, the Agency Cost of Free Cash Flow in this hypothesis implies that a high growth rate company has less motivation to pay dividends in generous amount because this company has high propensity to use their internal generated funds to finance its growth. According to these theories, a high growth rate company pays fewer or less dividends.

In the Residual Theory of Dividends, the dividends will be paid if the company has a net residual income after doing the investment opportunity for its growth. If the company uses most of its net income for investment activity, then the dividend portion will be smaller (Gitman & Zutter, 2014). A high growth rate companies usually uses most of its revenue to finance the company growth, thus the chance of having residual income is low. Therefore, this company pays fewer dividends. Conforming to these theories, growth negatively affects the dividend payment.

Meanwhile, the Dividend Signaling Theory or Informational Content implies that high growth companies give good signal to the investors that the companies have good prospects in the future. Company who wants to enter capital market to raise new funds needs the trust of the investor. Therefore, according to the dividend signaling theory or informational content, growth has positive effect on dividend payment. Since there are conflicting predictions regarding the effects of growth on dividends from these theories, the third hypothesis is un-directional and stated as follows.

H_{03}: Growth does not significantly affect Dividend Payment

H_{A3}: Growth significantly affects Dividend Payment

2.3.4 The Effect of Agency Cost on Dividend Payment

Agency cost is the cost borne by shareholders to monitor the agents. The agency problem occurs because two parties have different interests. The managers may take actions that will be unprofitable for the shareholders, while the shareholders will invest on project that will increase their own welfare. To solve the conflict of interests, usually, the company will pay for monitoring costs to supervise activities in progress and to ensure that the manager is on the same wave length of the shareholders. If the monitoring costs incurred, then the agency costs will be reduced.

This research will use free cash flow as the proxy of agency cost. Free cash flow is the cash and other assets that the company is able to generate after required investment to maintain its asset base.

One theory that is underlying the agency cost hypothesis is the Agency Cost of Free Cash Flow Theory. Easterbrook (1984) stated that dividend payments can also alleviate agency problems. If the cash resources are distributed, then the size

of internally generated fund to the agents is also reduced. The managers will be force to seek external financing from capital market. Hence, dividend payment would benefit the shareholders.

Therefore, the fourth hypothesis is agency cost has significant positive effect on dividend payment.

H_{04}: Agency cost has no significant positive effect on Dividend Payment

H_{A4}: Agency cost has significant positive effect on Dividend Payment

2.3.5 The Effect of Firm Size on Dividend Payment

The firm's size has been one of the commonly used factors in previous studies. Lloyd et.al (1985), Holder et.al (1998) and Hedensted & Raaballe (2006) argued that the size of the company is one of the factors that have the largest influence on the dividend payout ratio. The measurements of the size have varied between studies even though the majority of previous studies have concluded that size is an important factor. Large firms usually have more diverse shareholders, for that reason it has to pay higher dividends in order to reduce agency costs (Lloyd et.al, 1985). Holder et.al (1998) stated that the capital market has better access since it is usually able to provide high collateral.

There are two theories that are underlying this theory, i.e. the Firm Life Cycle Theory of Dividends and the Agency Cost of Free Cash Flow Theory.

As mentioned in the previous section, the Firm Life Cycle Theory of Dividends is a theory based on the concept that as a firm becomes mature, it tends to have high free cash flow and low growth rates, thus mature firm pay higher dividends than young firm.

According to the Agency Cost of Free Cash Flow Theory, large companies are associated with the complex operations that leads to some problems related to monitoring the agents. Large companies tend to have more diverse shareholders. Thus, according to this theory, in order to reduce the agency cost large companies will pay higher dividends.

Therefore, the fifth hypothesis is firm size positively affects the dividend payment.

H_{05}: Size has no significant positive effect on Dividend Payment

H_{A5}: Size has significant positive effect on Dividend Payment

2.4 Research Framework

Based on the theoretical basis and previous research regarding the various relationships between profitability, leverage, growth, agency costs, firm size and dividend payment, the research framework is illustrated in Figure 2.1.

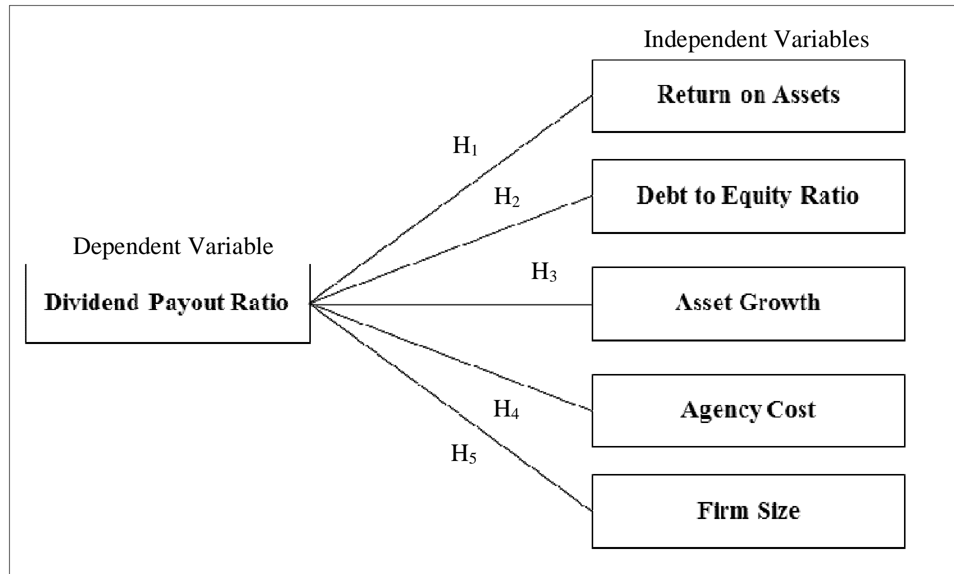

Figure 2.1 Research Framework