

# CHAPTER I

## INTRODUCTION

### 1.1 Background

In financial accounting, there are two important decisions that firm managers need to make: investment (or capital budgeting) decisions and financing decisions. Investment (or capital budgeting) decisions relating to the acquisition of the asset where it asks a firm to decide what real asset a firm should acquire. While financing decisions relate to how the acquired asset is financed (Malkawi et. al., 2010).

When firms are finally generating profit, a third decision comes in. This is a decision to choose whether all, none, or a proportion of a firm's profit is distributed to shareholders which are usually called dividend policy. The decided amount of dividend (the amount of which the firm's profit is distributed to shareholders) should not only factor the needed amount for the firm's investment but also shareholder's wealth (Al-Malkawi et al., 2010). This is because the dividend is one of the firm's major and important decision that the board of directors has to make (Berk et. al, 2015) as it may reflect the market price of the firm's share (Al-Malkawi et. al., 2010).

The importance of dividend policy leads to a dividend issue that has been long debated and has yet found an exact solution. Malkawi et. al., (2010) mentions that dividend policy is one of the issues that has troubled managers since the existence of commercial corporations around the middle of the last century which then leads to becomes one of the most debated issues in the finance world. Moreover, Malkawi

et. al. (2010) adds that finance critics have also attempted to solve the dividend issue by explaining corporate dividend behavior and defining theories on dividends.

Putting aside the dividend puzzle, it brings joy to shareholders when a firm decides to distribute its profit in terms of dividends to its shareholders. However, tax obligations on the dividends received cannot be denied. In the Indonesian tax system, this phenomenon relates to taxable dividends obliged by the Indonesian government. Two rates apply for taxable dividends: corporate rate and individual rate. Income tax chapter 23 applies to companies' taxable dividends which comprise 15% of the dividends' gross income. While income tax chapter 4 number 2 applies to individuals which comprise 10% of gross income.

The tax obligation that rises from dividend payments provides a challenge for financial economists as their purpose is to develop a dividend policy that maximizes the firm's profit but also maximizing investors' utility. Before the seminal contribution research by Miller & Modigliani (1961), it was widely accepted that the higher the dividend payments are given by a firm, the more valuable the firm becomes. This view was derived from the extension of the discounted dividends approach to firm valuation, which is formulated by the value of firm equals dividends in x year divided by one plus investment's opportunity cost of capital for period x.

However, Miller & Modigliani (1961) in their research point out that the previous method of defining a firm's value is flawed. The research focuses on the dividend irrelevance proposition where they found out that with perfect and

complete capital markets, a firm's dividend policy will not affect its value. Miller & Modigliani's (1961) basic argument is that a firm's value is determined by choosing optimal investments. Net payout on the other hand is the difference between earnings and investment and is simply a residual. As net payouts comprise of dividends and share issues and repurchases, a firm can adjust its dividends to any level with an offset of the number of shares outstanding the firm has. With the premise in mind, investors would view dividend policy as irrelevant as any desired stream of payment can be replicated by appropriate purchases and sales of equity.

Despite the irrelevancy of any desired stream of payment from the investor point of view (Miller & Modigliani, 1961) and even with the development of the financial and investing world bringing into existence share trading that produces a new world of investment, shareholders still have the desire to receive dividends despite the tax obligation they need to pay to the government as companies give out dividends. Moreover, companies believe that information within dividends can provide positive signals to investors (Rizqia et. al., 2013).

In research of cash flow and dividend policy in emerging markets, it is found that cash flow is influential towards dividend policy in a study of companies (Abor & Bokpin, 2010). Moreover, according to Abor & Bokpin (2010) companies with high profit tends to give out high dividend payments to their shareholders while firms in the relatively well-developed market tend to give lower dividend payout to their shareholders (Abor & Bokpin, 2010). Adil et. al. (2011) research on determinants of dividend policy found that liquidity (as measured by cash flow from operating activities) has a strong and significant relationship with dividend policy.

In another research conducted by Afza & Mirza (2010) on the determinants of dividend policy found that operating cash flow is positively related to dividend policy. Mehta's (2012) research on determinants of dividend policy with evidence from UAE companies, found that size, risk, and cash flow (only ROE) are the most significant variables influencing the dividend decisions of UAE firms. Where these three variables explained that 42.8% of the total variation of dividend payout ratio.

In Imran's (2011) research on determinants of dividend policy in Pakistan's engineering industry, he found that profitability has a positive effect on dividend policy. Furthermore, in Afza & Mirza (2010), Paminto et. al., (2016) and Ajanthan (2013) research also found the same result as Imran (2011) on corporate dividend policy where there is a positive and significant effect of profitability on dividend policy. However, in Tamrin et. al., (2017), Kuzuchu (2015), and Maladjian & Khoury's (2014) research on determinants of dividend policy, it is found that there is a significant and negative relationship between profitability and dividend policy.

Data used for this study will include materials and health care public-listed companies in the Indonesia Stock Exchange which is the official website for publicly listed companies in Indonesia to fulfill their responsibility to its shareholders (investors) as well as other related parties who may need firm information during the related period. The period of observation is limited to 2017 - 2019 because this paper believes that period chosen is relevant to the period the study is conducted since it represents the latest firm profile.

Based on listed theories (opinions) by finance scholars and previous research elaborated above, this paper wishes to further examine whether profitability and cash flow as proxied by ROA and net cash flow from operating activities affect companies' dividend policy. In summary, this paper takes the title of **“THE EFFECT OF CASH FLOW AND PROFITABILITY ON DIVIDEND POLICY.”**

### **1.2 Research Problem**

About the background of the study, it is known that cash flow and profitability may affect dividend policy made by financial managers and/or the board of directors. Therefore, this paper wishes to investigate further the research problems as follows.

1. Does profitability negatively affect dividend policy?
2. Does cash flow negatively affect dividend policy?

### **1.3 Research Objective**

In determining the purpose of the study, this paper holds strongly to the research problems. Therefore, this paper constructs the following objectives of the study:

1. Prove that profitability negatively affects dividend policy.
2. Prove that cash flow negatively affects dividend policy.

## 1.4 Significance of the Study

### 1. This paper

This paper wishes to provide deeper knowledge regarding the issue of dividend policy and the application of knowledge gained during the process of learning in the university.

### 2. *Universitas Pelita Harapan*

This paper wishes that the result of this study may hopefully give additional knowledge to the application of theories taught during the classes taken in university as well as additional materials that may arise through this study. Finally, hopefully, this study brings an addition to the literature collection of Johannes Oentoro Library of *Universitas Pelita Harapan*.

### 3. Future studies

This paper wishes that the result of this study results may hopefully be used as additional knowledge and/or base knowledge for future studies relating to the effect of cash flow and profitability on a firm's dividend policy.

### 4. Literature reference

This paper wishes that the result of this study hopefully can contribute to literature or research regarding dividend policies in Indonesia. Especially in the factors influencing managers' dividend policy decisions. Additionally, this study could contribute an additional literature consideration for companies in Indonesia to establish decisions regarding the distribution of their income especially in terms of dividend distribution.

### 5. Stakeholders

This paper wishes that the result of this study can be useful for decision-making processes related to cash flow, dividend policy, profitability. Furthermore, hopefully, this study could bring up a new perspective for the board of directors and/or managers of a firm in their day-to-day and long-term decisions relating to the firm's dividend policy which plays an important role in the investor's point of view.

### **1.5 Scope of the Study**

In this study, this paper is studying the effect of cash flow and profitability on the firm's dividend policy. Profitability is measured by using the return on asset formula while cash flow is measured by net cash from operating activities.

### **1.6 Systematic Discussion**

This research will be divided into five chapters as follows.

#### **CHAPTER I INTRODUCTION**

This chapter will include subchapters including background, research problem, research objective, the significance of the study, the scope of the study, and systematic discussion.

#### **CHAPTER II THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT**

This chapter will first elaborate in detail its big theory (main theory used in this study), then some other related literature review, conceptual framework, and hypothesis development.

### CHAPTER III METHODOLOGY

This chapter will elaborate on which method of research is being used in this study. This includes the population and sample, the empirical model, operational variable definition, and method of data analysis.

### CHAPTER IV RESULT AND DISCUSSION

This chapter will discuss the result and empirical findings in the study with the study's focus which is the effect of cash flow and profitability on a firm's dividend policy.

### CHAPTER V CONCLUSION

This chapter consists of a conclusion and suggestion from the result and discussions from preceding chapters and recommendations for future research in the same field of focus.