CHAPTER 1

INTRODUCTION

1.1. Research Topic Background

Investment activity has always been a challenging financial activity for investors as it always involves various risks and uncertainties, which are hard to predict. In order to reduce the degree of risks and uncertainties, it is common for investors to gather information from many different sources, including financial report and nationwide newspapers (Difah, 2011). Investors are able to learn about each company's general business practice, its recent and future business plans and its financial performance through its financial reports. In addition, investors generally consider the surrounding economic and politic situations where the company situated before making further investment decisions. Investors and their financial investment are frequently reported in many studies to have a primary objective of getting high return in the terms of dividends and capital gains (Risaptoko, 2007).

Similarly to the investors, all companies also face numerous financial risks when they engage in complex procedures to make decisions in regards to their revenue management. Companies need to sort their priorities among the choices of investing income in operating assets, business expansion, paying off debts and/ or distributing back to investors. Distributing profits to investors is crucial as it shows certainty about the financial wellbeing of a company (DeAngelo et. al., 2006). When it comes to the distribution of profits to the investors, companies once again encounter two options of whether the distribution should be in cash or shares (Damayanti and Achyani, 2006). This complex decision-making procedure in regards to the distribution of profits to investors is commonly known as the dividend policy in the financial literature.

Due to its complexity nature for both investors and companies, dividend policy has always been in the core theory of finance (Nacuer et. al., 2007). It has been one of the top ten difficult topics in the finance literature (Denis, 2008). Many studies have tried to devise dividend theories and provided statistical evidences regarding the determinants of dividend policy. The dividend policy issue, however, has remained unresolved until now. The world of finance still live in the dividend puzzle as there are still no clear guidelines for an optimal payout policy regardless of the emerging various literatures. With all of the on-going popular notes, this research study decides to keep its focus on the relationship of dividend payout ratio and its determinants.

The word “dividend” itself in the world of finance is defined as the amount of profits returned by companies to their investors for their investment and these returns could be in the terms of cash or shares (Hatta, 2002). According to Syahbana (2007), investors prefer to earn cash dividend rather than share dividend because cash dividend could attract investors' interest as well as decrease their uncertainties on their investment decision. Furthermore, Hadiwijaya and Triani (2009) state that investors generally hope for relatively stable dividend because dividend stability shows a healthy financial performance and investors get attracted to companies with healthy financial performance. With this note from investors' point of view, companies are in need to provide returns for investors in order to keep them interested in investing on their companies while they need to manage their profits for future growth purposes (Yuniningsih, 2002).

As mentioned earlier, both investors and companies have huge concerns about dividend payout policy, however their concerns are contrasting. The dividend policy assists companies to structure the allocation of their profits for, firstly, their retained earnings that they would serve as reserved cash for future investment; and secondly, their dividend payouts that they would distribute to their investors (Denis and Osobov, 2008). Furthermore, Pruitt and Gitman (1999) add that both amount of retained earnings and dividend are equally important for companies because this distribution structure of retained earnings and dividend payouts could set the reputation among the public of where the companies is heading; and also, it could shape the trust, confidence and interest among the investors about their investment into the companies. When the public interest and confidence increase, the price of the shares tends to follow the upcoming trends (Difah, 2010).

Meanwhile, for investors, the dividend policy assists them to measure the gain from the investment that they have placed into the companies (Sunarto and Kartika, 2003). At many times, the amount of dividend payout becomes motivation for investors to decide whether or not they would continue or add or withdraw their investment in their chosen companies. As mentioned by Fauziah (2010), investors tend to employ risk aversion that means they are more interested in the dividend payout rather than the capital gain from their investment. This presumption is aligned with “the bird in the hand theory.” The theory proposes that dividend payout reduces the current uncertainties, which mean less investment risks (Kadir, 2010). Investors are said to be more satisfied with dividend payouts than company profits because the company profits that are not given out as dividend may not become dividends in the future due to unexpected adverse company expansion or investment.

The dividend policy is challenging and also interesting to study for it engages two opposing sides, which are the companies and the investors. They both clearly have different interests in the dividend payout policy. Deitiana (2009) states that every decision on dividend policy always brings about two opposing outcomes. When all profits are all paid out as dividends to investors, then the importance of retained earnings are ignored. On the other hand, when all profits are retained as reserved capital then the objective of investors about getting dividend is disregarded. It is then the goal of every management to undertake optimal decisions on dividend policy in order to balance both companies and investors intentions. Optimal dividend policy is necessary to create fine balance between current dividend payouts and retained earnings for future growth.

Many studies around the world have tried to discuss in depth in regards to dividend payout policy. Modigliani and Miller (1961) are the pioneer couple in the subject area of dividend payout policy with their theory of irrelevance. Their irrelevance theory proposes that if a financial market is perfectly efficient, then how a company is a financed has no bearing on its performance. It states that a company's dividend policy is irrelevant to the source of company’s funding. Therefore, dividend payout policy would be irrelevant to the share price.

In contrast to the irrelevance theory, many scholars believe that perfect financial market does not exist. Consequently, they advise signaling theory that suggests companies have reason to give out high rate of dividends (Amidu and Abor, 2006). The announcements of an increase in dividend payouts act as an indicator of the company’s future prospects. A company who has good investment opportunities is more likely to "signal" than one who does not because it is in its best interest to do so.

Another prominent theory is agency theory proposed by Jensen and Meckling (1976). This theory highlights the cost of resolving interest cost between principal (investors) and agent (company's managers); and proposes a solution to balance interest between the two groups.

Fama and French (2001) also contribute a significant dividend literature through their theory on the evolution of opportunity sets. This theory states that companies optimally alter dividend through time in response to the evolution of their opportunity set. DeAngelo and DeAngelo (2006) also provide an alternate view of dividend payout policy. They propose that optimal dividend payout policy is driven by the need to distribute a company's free cash flow. They also promote a life-cycle theory that combines elements of Jensen's (1986) agency theory with evolution in the company's investment opportunity sets discussed by Fama and French (2001).

The on-going debates over dividend payout policy focus on the question on how much dividend should a company distribute to its investors. At this point, companies need to evaluate some factors in deciding the amount of dividend payout (Hatta, 2002). The decision-making process have become very complex and put the management at a dilemma, as there are many factors to consider. It is documented that it is hard for companies and their managers to evaluate the major factors in the dividend payout policy.

Many researches have been done to determine the major factors in the dividend payout policy. Parthington (1989) proposes five significant factors on company's dividend payout policy; they are profitability, liquidity, leverage, assets growth and company size. The ability of a company to gain profit is reported to be the most significant factor for that particular company to payout dividends. Therefore, profitability is often regarded as the primary factor in the dividend payout policy (Lintner, 1956).

Regardless, the other factors are also identified in the financial literature as being important and customary in the dividend payout policy (Koch and Shenoy, 1999). Liquidity is considered important because it defines the ability of a company to convert its assets to cash and to fulfill its near-future financial needs; and current ratio is one of the popular tools used to measure a company's liquity (Primawestri, 2011). Moreover, Prihantoro (2003) states that leverage is also important because it measures the ability of a company to meet its financial obligations. According to Puspita (2009), debts to equity ratio and debt to assets ratio are two acceptable tools to measure leverage. Furthermore, assets growth is also often regarded as a valuable indicator of future stock returns (Copper et. al., 2009). The last but not least, many researches use company size as an additional variable in evaluating the dividend payout ratio. It is considered as an important explanatory variable because large companies are more likely to increase their dividend payouts to decrease agency costs (Al-Kuwari, 2009).

Many international and national academic scholars have done many researches on the factors of dividend payout ratio. The following are some selected study and their results.

Al-Kuwari (2009) focuses his study on the factors of dividend payout ratio among the Gulf Co-operation Council countries. His study results conclude a positive relationship between return on total asset and dividend payout ratio; a negative significant relationship between debts to total asset and dividend payout ratio; a positive significant relationship between company size and dividend payout ratio and a positive relationship between government ownership of a company and dividend payout ratio.

Gill et. al. (2010) also focus their study on the factors of dividend payout ratio and their sample is 266 non-finance companies in the U.S.A. Their study results firstly show a negative relationship between assets growth and dividend payout ratio; secondly, a negative relationship between debts to equity ratio and dividend payout ratio; thirdly, a negative relationship between net profit margin and dividend payout ratio; a positive significant relationship between sales growth and dividend payout ratio; and lastly, a positive not significant relationship between taxes and dividend payout ratio.

Other international researchers are Ben et. al (2007) who complete a study together with the topic of dividend payout determinants among the Tunisian companies. Their study surprisingly shows there is no relationship between debts to total asset and dividend payout ratio. Also, there is no relationship between managers ownership of a company and dividend payout ratio. Furthermore, their study shows there is a positive significant relationship between return on total asset ratio and dividend payout ratio.

Nuringsih (2005) conducts her study on the factors of dividend payout policy and her sample is 60 Indonesian manufacturing companies that were listed in the Indonesia Stock Exchange and continuously distributed dividends from 1995 to 1996. She uses return on total asset ratio to measure the profitability and finds out that dividend payout is negatively associated with profitability. Her study also reveals a negative relationship between leverage and dividend payout ratio. Moreover, her study shows a non-significant relationship between cash ratio and dividend payout ratio.

Syahbana (2007), with his sample of 31 Indonesian go-public companies that continuously distributed dividends from 2003 to 2005, confirms Higgins' finding that assets growth has a negative not significant relationship with dividend payout ratio. He also finds a negative relationship between debts to total asset and dividend payout ratio, which confirm the finding of Pruitt and

Gitman (1991). In addition, he reveals a positive significant relationship between return to total asset and dividend payout policy. Moreover, he agrees through his research that there is a positive relationship between company size and dividend payout ratio.

Puspita (2009) also focuses her study on the factors of dividend payout ratio. Her sample is 26 public Indonesian companies, specifically in the sector of non-finance. Her study results are a positive significant relationship between return to total asset and dividend payout ratio, a negative significant relationship between debts to total asset and dividend payout ratio, a negative significant relationship between assets growth and dividend payout ratio, a positive significant relationship between company size and dividend payout ratio, a positive relationship between cash ratio and dividend payout ratio, and lastly a negative not significant relationship between debts to equity ratio and dividend payout ratio.

Utami (2008) also enriches the dividend payout evidences. With her sample of manufacturing go-public Indonesian companies that continuously distributed dividends from 2003 to 2005, she indicates that current ratio and net profit margin do not show any significant influence on dividend payout ratio.

Another researcher trying to give more evidence on the topic of dividend payout ratio among manufacturing companies Indonesia is Usman (2006). His finding suggests a positive relationship between assets growth and dividend payout ratio. His finding also suggests a positive significant relationship between debts to equity ratio and dividend payout ratio.

With a relatively small sample of 10 Indonesian credit agencies that continuously distributed dividends from 2003 to 2007, Abdul Kadir (2010) publishes his findings: a negative relationship between debts to equity ratio and dividend payout ratio; a positive not significant relationship between current ratio and dividend payout ratio; a significant relationshipship between company size and dividend payout ratio and a significant relationship between return on investment and dividend payout ratio.

Also, Deitiana (2009) adds more evidences on the topics of dividend payout ratios. With her sample of 21 go-public non-finance Indonesian companies that continuously distributed dividend from 2003 to 2007, she finds out that return to total asset, debts to equity ratio, current ratio and net profit margin do not significantly affect dividend payout ratio. Then, she also finds out earning per share has a positive relationship with dividend payout ratio.

Rini Hadiwijaya (2008) conducts study on the dividend payout too. Her sample is 31 manufacturing companies that were listed on Indonesia Stock

Exchange that continuously distributed dividend from 2001 to 2005. Her findings show a positive significant relationship between debts to equity ratio and dividend payout ratio; a positive significant relationship between current ratio and dividend payout ratio; a significant relationship between return on investment and dividend payout ratio; and a positive not significant relationship between net profit margin and dividend payout ratio.

Similarly to many other financial researchers, Risaptoko (2007) also picks the topic of dividend payout factors among the Indonesian companies for his study. The results show that there is no relationship between return to total asset and dividend payout ratio, assets growth and dividend payout ratio, and also company size and dividend payout ratio. However, there is a positive relationship between debts to total asset and dividend payout ratio, and also current ratio and dividend payout ratio.

Kumar, with his sample of 40 Indonesian companies that were listed in the Indonesia Stock Exchange and continuously distributed dividends from 2003 to 2005, shows a positive significant relationship between return to total asset and dividend payout ratio. In addition, it shows a negative not significant between debts to equity ratio and dividend payout ratio. Moreover, it shows a not significant relationship between management ownership of company and dividend payout ratio.

Prihantoro (2003) also completes a study on dividend payout factors among 148 Indonesia companies that were listed in the Indonesia Stock Exchange from 1991 to 1996. His study reveals a negative significant relationship between debts to equity ratio and dividend payout ratio. In addition, it reveals a positive significant relationship between current ratio and dividend payout ratio. Also, it reveals a not significant relationship between return to total asset and dividend payout ratio, and also company size and dividend payout ratio.

From the above several studies, it can be summarized that there are 13 independent variables commonly used in the researches of dividend policy ratio. From these 13 variables, 7 variables are selected for this study because these 7 variables of dividend payout ratio show inconsistent findings across several studies that are conducted with different time frame and different regions, internationally and nationally. These 6 factors are return to total asset (ROA), net profit margin (NPM), current ratio (CR), debts to total asset (DTA), debts to equity ratio (DER), assets growth and company size.

Table 1.1.

Summary of Previous Research Findings on Dividend Payout Ratio

Researcher Name (Year of Research)	Return on Assets (ROA)	Net Proft Margin (NPM)	Current Ratio (CR)	Debt to Assets (DTA)	Debt Equity Ratio (DER)	Assets Growth	Firm Size
Al-Kuwari (2009)	+ significant			- significant			+ significant
Gill, Biger and Tibrewala (2010)		-			-	-	
Nacuer, Goaied and Belanes (2007)	+ significant			no relationship			
Nuringsih (2005)	-			-			
Syahbana, A. (2007)	+ significant			- significant		- not significant	+ not significant
Puspita, F. (2009)	+ significant			- significant	- not significant	- significant	+ significant
Utami (2008)		not significant	not significant				
Usman (2006)	+ significant				+ significant	+	
Kadir, A. (2010)			+ not significant		-		significant
Deitiana, T. (2009)	not significant	not significant	not significant		not significant		
Hadiwijaya, R. (2008)		+ not significant	+ significant		- not significant		
Risaptoko (2007)	no relationship		+	+		no relationship	no relationship
Kumar, S. (2007)	+ significant				- not significant		
Prihantoro (2003)	not significant		+ significant		- significant		not siginificant

1.2. Research Challenges and Problem Identification

With the above a brief financial model on the factors of dividend payout ratio, it can be seen that there are empirical gaps between the model theory, the diverse independent variables and the inconsistent findings from various researches conducted through different time frame and different region, internationally and nationally. Therefore, more future researches on the factors of dividend payout ratio are needed to give more justifications and explanations.

Many previous researches have shown inconsistent results on the selected seven factors (independent variables) of dividend payout ratio shown in the table 1.1.

The first independent variable is profitability, which is measured with return to total asset. The supposition believes there is a positive relationship between return of assets and dividend payout. The thinking behind this is that when a company has a high rate of profitability, it has the amount of profits to distribute as dividends. Therefore, investors are more likely to receive dividends. At the international settings, Al-Kuwari (2009) and Nacuer et. al. (2007) support the supposition that return to total asset has a positive relationship with dividend payout. The studies at the national level of Indonesia by Syahbana (2007), Kumar (2007) Puspita (2009) also confirm the supposition that return to total asset has a positive relationship with dividend payout. However, on contrary, Nuringish (2005) with her study shows that return to total asset has a negative relationship with dividend payout. Risaptoko (2007) also disagree with the supposition, as his study reveals no relationship between return to total asset and dividend payout.

The second independent variable is net profit margin (NPM), which also measures profitability like return to total asset. The results of previous studies are diverse. Gill et. al. (2010) with their sample of 266 non-finance U.S.A. companies, surprisingly say that net profit margin has a negative relationship with dividend payout. On contrary, Hadiwijaya (2008) finds out that net profit margin has a positive significant relationship with dividend payout. Meanwhile, Utami (2008) and Deitiana (2009) state that their studies show no relationship between net profit margin and dividend payout.

The third independent variable is current ratio (CR), which measures liquidity. Prihantoro (2003), Risaptoko (2007), Hadiwijaya (2008) and Kadir (2010) are on agreement that current ratio has a positive relationship with dividend payout ratio. However, Utami (2008) and Deitiana (2009) disagree with the result tendency as their studies show a not-significant relationship between current ratio and dividend payout ratio.

The fourth independent variable is leverage aspect, which is measured with debts to total asset (DTA). The tendency is debts to total assets as a leverage factor has a negative relationship with dividend payout. The idea is that the more a company has debts, the more assets are needed to pay off the debts. Therefore, dividend is more likely to be less. Nuringsih (2005), Syahbana (2007), Puspita (2009) and Al-Kuwari (2009) with their studies, strongly confirm the tendency results. However, Risaptoko (2007) disagree with the supposition because his study shows a negative relationship between debts to total asset and dividend payout.

The fifth independent variable is also a leverage variable, which is debts to equity ratio (DER). Similarly like debts to total asset, the supposition is debts to equity ratio has a negative relationship with dividend payout. Studies by Prihantoro (2003), Hadiwijaya (2007), Kumar (2007), Puspita (2009), Gill et. al. (2010), Kadir (2010) confirm the supposition. However, Usman (2006) reveals that his study show a positive relationship between debts to equity ratio and dividend payout ratio.

The six independent variable is assets growth. Usman (2006) say that assets growth has a positive relationship with dividend payout. However, Syahbana (2007), Puspita (2009) and Gill et. al. (2010) disagree with Usman. They say the opposite, which is assets growth has a negative relationship with dividend payout because when companies invest more on assets, the money for dividends are used up and therefore investors are less likely to earn dividends. On different study result, Risaptoko (2007) instead say there is no relationship between assets growth and dividend payout.

The last independent variable is company size. Syahbana (2007) and Puspita (2009) agree that company size has a positive significant relationship with dividend payout ratio. Al-Kuwari (2010) also reveals that his study show a positive relationship, but not significant relationship between Company Size and dividend payout ratio. However, Prihantoro (2003) disagree with the result tendency as his study shows a not significant relationship between company size and dividend payout ratio. On the line with Prihantoro (2003) and Risaptoko (2007) also disagree with the result tendency as his study shows a no relationship between company size and dividend payout ratio.

1.3. Research Scope

With the notion of dividend policy dilemma and the inconsistent findings of dividend payout factors, this study focuses on the selected seven variables in the dividend policy ratio and to test its significance influence to the dividend policy.

The study focuses on Indonesia, a country where the study will be conducted and where the researcher comes from. The decision to choose Indonesia is supported by the need of data gathering. While living in Indonesia, collecting data on go public Indonesian companies and observing national economy becomes easier for the researcher to complete this study. With this reason, choosing Indonesia seems appropriate than choosing other countries or regions. Furthermore, Indonesia is considered as one of the top emerging countries with an economy growth of 6.3% in the first quarter of 2012 (BBC

News, 2012) and an investment target of USD $22.4 billion in 2012 (Nasdaq, 2012).

This study selects its sample from public companies that are listed in the Indonesia Stock Exchange to ease and ensure the availability of the financial data as every public company is required to publish their yearly financial data to the public.

This study specifically focuses its sample on the non-finance companies. The rationale behind this decision is that finance companies tend to have consistent high dividend payout due to its nature of business (Puspita, 2009). It only makes sense and appealing for every finance company to distribute dividends to portray their financial performance stability. Furthermore, Bill et. al. (2010) add that the dividend payout ratio and their variables are more statically incoherent among the non-finance sector. This means that the non-finance companies tend to have different adjustments and inconsistent low payout ratio, which represent the fluctuation in their dividend payouts. Therefore, non-finance companies become more appropriate to be taken as sample in this study as they have inconsistent findings and also they eliminate the statistical biases from financial companies.

With the sample group of non-finance companies, this study becomes a replicate of study of Puspita (2009), Deitiana (2009), Al-Kuwari (2009), and

Bill et. al. (2010). However, this study has different time frame and dependent variables.

In terms of time frame, this study selects the years of 2008, 2009, 2010 and 2011 in order to provide findings with the most recent data. In addition, the four years period is chosen to provide a degree of consistency in the pattern of dividend payouts.

As mentioned earlier, the seven selected variables of dividend payout ratio for this study are as the following:

1. Return to total asset (ROA)
2. Net Profit Margin (NPM)
3. Current Ratio (CR)
4. Debts to Total Asset (DTA)
5. Debts to Equity Ratio (DER)
6. Assets Growth
7. Company Size

Once again, these seven variables are selected because many previous studies show inconsistency of findings in these six factors.

1.4. **Research Objectives and Questions**

Many previous researches and publications have shown that dividend payout policy is a complex yet interesting subjects in the financial world. There are many theories built to discuss and analyze the dynamic performance of dividend payout policy around the world from time to time. However, it is often found that the real data findings from many studies do not conform to the available theories. Both independent and dependent variables of dividend policy repeatedly yield unpredicted results from time to time, therefore more studies with recent data are needed to provide with more knowledge reflecting the recent performance of dividend payout policy.

With this notion, this research aims to discuss and explore the influence of financial factors, including profitability, liquidity, leverage and growth on the dividend payout policy. The major question has been formulated for this research is "Do companies' profitability, liquidity, leverage and assets growth have significant relationship on the companies' dividend payout ratio?" This major question is then broken down in details to the following seven questions:

1. Does return to total asset (ROA) that represents profitability have a positive relationship with the dividend payout ratio of the non-finance companies that are listed in the Indonesia Stock Exchange from 2008 to 2011?

2. Does net profit margin (NPM) that represents profitability have a positive relationship with the dividend payout ratio of the non-finance companies that are listed in the Indonesia Stock Exchange from 2008 to 2011?
3. Does current ratio (CR) that represents liquidity have a positive relationship with the dividend payout ratio of the non-finance companies that are listed in the Indonesia Stock Exchange from 2008 to 2011?
4. Does debts to total asset (DTA) that represents leverage have a negative relationship with the dividend payout ratio of the non-finance companies that are listed in the Indonesia Stock Exchange from 2008 to 2011?
5. Does debts to equity ratio (DER) that represents leverage have a negative relationship with the dividend payout ratio of the non-finance companies that are listed in the Indonesia Stock Exchange from 2008 to 2011?
6. Does assets growth have a negative relationship with the dividend payout ratio of the non-finance companies that are listed in the Indonesia Stock Exchange from 2008 to 2011?
7. Does company size have a positive relationship with the dividend payout ratio of the non-finance companies that are listed in the Indonesia Stock Exchange from 2008 to 2011?

1.5. Research Advantages

With the above research objectives and questions, this research attempts to find satisfying answers by exploring the available theories and past researches on the six selected variables of dividend policy, testing its significance relationship with the dividend payout policy and discussing the research findings and its relevancy with the available theories and past researches.

This research is expected to fill the gap in the academic papers on dividend payout policy among the non-finance companies that are listed in the Indonesia Stock Exchange. Furthermore, this research could provide more source of information for firstly the public in understanding the recent dynamics performance of dividend payout policy in Indonesia, secondly the companies in making decisions about dividend payout policy and thirdly the investors in making decisions and expecting their investments and their dividend returns. Moreover, this research could add to the available literature and could serve as a guideline for students to conduct further researches on dividend payout ratio in the near future.

1.6. **Research Structure**

This research consists of five chapters as the following:

1. Introduction

The introduction chapter highlights the research topic background, the problem identification, the research scope, the research question formulation, the research objectives and benefits, and the research structure.

2. Literature Review

The literature review chapter serves as an initial stage of the research study by providing a comprehensive theoretical foundation and findings from past researches on dividend payout policy. This chapter also briefly discusses several factors that are believed to have significant relationship with dividend payout ratios.

3. Research Methodology

The research methodology chapter describes in detailed on how the research is conducted. It also provides the reasons behind the selection of sample and statistical results.

4. Research Findings and Analysis

The research findings chapter summarizes the findings of the statistical tests conducted in the chapter 3. This chapter also provides a brief analysis of the research findings, explanations and its relevancy to the available theories and past researches.

5. Conclusion and Recommendations

This last chapter eventually wraps up the research by drawing highlights of the research background, the research process and the research findings. At last, this chapter proposes some recommendations that are built upon the research findings and discussions.