# CHAPTER I
# INTRODUCTION

## 1.1. Background of the Study

The nearly universal policy of paying substantial dividends is the primary puzzle in the economics of corporate finance. Dividends are taxed at rates varying up to 20 percent and averaging around 15 percent. In contrast, retained earnings imply no concurrent tax liability. The rise of the share value that is resulted from the retained earnings is taxed only when the stock is sold and then at least 99.9 percent of the gain is untaxed. In spite of this significant of the penalty, some of Indonesian corporations continue to distribute a major fraction of their earnings as dividends over several decades (PWC Indonesian Pocket Tax Book, 2011)

Every company is established with different purposes but they all have one basic goal, which is to maximize shareholders' wealth. Companies try to satisfy this goal by either developing and increasing the companies' value by keeping it as retained earnings, or by distributing that value through paying dividends to shareholders who hold ownership of the companies. Dividends usually refer to cash paid out of earnings (Ross, Westerfield, and Jordan, 2008).

Companies usually do not give all the earnings as dividends but rather keep some of it as retained earnings that will be reinvested through capital expenditure or other means of investment. The decision to choose between the two options, known as dividend policy, rests fully in the hands of the board of management. Therefore, dividend policy is a managerial decision to determine the portion of dividend payout compared to the portion of retained earnings. "The heart of the dividend policy question is just this: Should the firm pay out money to its shareholders, or should the firm take that money and invest it for its shareholders?" (Ross, Westerfield, and Jordan, 2008)

The way every company thinks and decides its dividend payout ratio is different. Decisions about dividend policy are made according to some considerations such as taxes and floating costs (Ross, Westerfield, and Jordan, 2008), and some characteristics such as profitability, investment opportunities, and size (Y. Subba Reddy and Subhrendu Rath, 2006). Y. Subba Reddy and Subhrendu Rath examined the number of firms in India that paid dividends during the period of 1991-2001, revealing that some companies do not even pay any dividends. During this period, the number of companies that paid dividends decreased over time.

Table 1

**Dividend-Paying and Nonpaying Firms**

| | Dividend payers | | Nonpayers | | Payers (percent) | | | Nonpayers (percent) | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Year | Number of payers | Payers (percent) | Number of nonpayers | Nonpayers (percent) | Regular payers (percent) | Initiators (percent) | New listings (percent) | Never paid (percent) | Former payers (percent) | New listings (percent) |
| 1991 | 1,204 | 57.9 | 875 | 42.1 | 44.44 | 0.00 | 13.47 | 24.87 | 2.50 | 14.72 |
| 1992 | 1,428 | 60.7 | 925 | 39.3 | 47.34 | 1.44 | 11.90 | 28.01 | 3.53 | 7.78 |
| 1993 | 1,646 | 57.9 | 1,197 | 42.1 | 43.02 | 3.13 | 11.75 | 24.62 | 5.52 | 11.96 |
| 1994 | 2,071 | 56.8 | 1,573 | 43.2 | 39.00 | 4.80 | 13.04 | 23.38 | 5.76 | 14.02 |
| 1995 | 2,390 | 52.9 | 2,127 | 47.1 | 37.10 | 5.56 | 10.25 | 26.08 | 6.93 | 14.08 |
| 1996 | 2,251 | 46.3 | 2,606 | 53.7 | 34.65 | 6.09 | 5.60 | 33.52 | 13.03 | 7.10 |
| 1997 | 1,994 | 39.5 | 3,051 | 60.5 | 29.53 | 6.66 | 3.33 | 35.32 | 19.43 | 5.73 |
| 1998 | 1,794 | 34.9 | 3,348 | 65.1 | 24.93 | 7.18 | 2.78 | 36.52 | 24.21 | 4.38 |
| 1999 | 1,723 | 32.0 | 3,653 | 68.0 | 21.24 | 7.40 | 3.40 | 34.99 | 26.93 | 6.03 |
| 2000 | 1,701 | 31.7 | 3,659 | 68.3 | 20.69 | 8.45 | 2.59 | 36.64 | 28.19 | 3.43 |
| 2001 | 1,334 | 32.3 | 2,793 | 67.7 | 21.71 | 9.09 | 1.53 | 34.65 | 32.54 | 0.48 |
| 1991–1995 | 8,739 | 57.2 | 6,697 | 42.8 | 42.18 | 3.73 | 12.08 | 12.08 | 4.85 | 12.51 |
| 1996–2001 | 10,800 | 36.1 | 19,110 | 63.9 | 25.46 | 7.48 | 3.21 | 3.21 | 24.06 | 4.53 |

*Notes:* Regular payers are those firms that have paid dividends regularly without ever skipping dividend payments. New listings payers are those firms that list and start paying dividends during the same year. Initiators are those that are listed prior to the current year but start paying dividends in the current year. Nonpayers are categorized into never paid, former payers, and new listed nonpayers. Never paid firms are those that have never paid any dividend up to a given year. Former payers are those that had paid dividends in some previous year but do not pay dividends in the current year. New listed nonpayers are those that are listed and have not paid dividends in the same year.

(Y. Subba Reddy and Subhrendu Rath, 2006)

Table 1.1

After seeing the table above, there is one question that arises: Why do firms initiate dividends? For so many years, financial scholars and economists have tried to figure out this question. Many possible explanations have arisen to cover this issue. Dividend initiation is the first public indication of managers' willingness to return excess or free cash to shareholders instead of investing in new or ongoing projects. By initiating regularly, companies will increase shareholders' loyalty due to the expectation to receive dividends regularly in foreseeable future (Sharma, 2001). Another explanation is the desire of the part of small investors that want to receive a steady stream of dividend to finance their consumption. Even though the tax for dividends is quite high, the still prefer receiving dividends to sell their shares regularly to cover their consumption because it will imply a good amount of transaction costs (Feldstein and Green, 1983). A more plausible explanation is that dividends are required as there is a separation between ownership and management. The management choose a dividend policy to communicate the level and growth of the real income that as traditional accounting report could not handle the current income and future prospects. But this explanation is not valid if there is a world crisis such as in 2008-2009. The Subprime Mortgage crisis in 2008 caused the large scare in the global financial markets, and the international stock and foreign markets suffer heavy shock (Hsien and Yi Lee, 2012). There could be also the notion that shareholders as the owner distrust the management and fear that the retained earnings will be waste in poor investment, high management compensation, etc (Feldstein and Green, 1983). For smaller firms which are more likely to be faced with a high asymmetric information and high transaction costs will prefer to use internal funding such as reduce the dividend payout (Y. Subba Reddy and Subhrendu Rath, 2006). Firms with more of investment opportunities are less likely to distribute the dividend and rather use the free cash to funding their investment opportunities.

In Indonesia, this phenomenon is also happened, is not all companies regularly pay dividends, even some of them do not pay the dividends although their net earning is positive and supposed to be able to pay the dividends. As listed companies, they have to share their profits to their shareholders (vivanews.com, tuesday may 5th, 2009). Related to this issue, Indonesia Stocks Exchange committee has issued a regulation that govern on the company dividend policy. There is a policy draft about dividend that said every listed company must distribute dividends to its shareholders at least once every three years if it records net income, but until now that regulation has not finished and has not been ratified yet (indonesia finance today, tuesday october 25th, 2011). It still become a puzzle, how a company make a decision whether it will pay the dividend or not to its shareholders. Many possible explanations have been suggested.

Studies on catering dividend have shown mixed results. Ferris et al. (2006) shows that there is catering incentives on dividend payment in UK. Nopphon Tang jitprom (2011) studied on catering theory of dividends in Thailand and found that the dividend premium has significant effect on the propensity to pay dividends. However, Denis and Osobov (2008) explain that the declining dividends in Germany and France is not significantly affected by catering incentives of dividends.

Based on the mixed results of several studies about the effect of dividend premium on the dividend payment decision, the writer decide to make this paper that talks about the effect of dividend premium on the dividend payment decision in Indonesian Stock Exchange market.

## 1.2. Research Problems

1.2.1. Do Indonesian investors prefer dividend payment?

1.2.2. Does dividend premium has significant effect on the propensity to pay dividends?

## 1.3. Research Objectives

1.3.1. To analyze if Indonesian Investors prefer dividend payment.

1.3.2. To analyze if dividend premium has significant effect on the propensity to pay dividends.

## 1.4. Research Contributions

1.4.1. Theoritically

This paper could help in the educational field to develop the theory about dividends and understanding more about the dividend payout policy.

1.4.2. Empirically

1.4.2.1. Managers

This paper could help managers get insight in the decision making of the dividend policy that will benefits the company.

1.4.2.2.Investors

This paper could help the investors to understand more about the type of investors in Indonesia before they decide to invest their money in the listed company in Indonesian Stock Exchange.

1.4.2.3.Traders

This could help the traders to predict the stock price in the dates around the dividend announcement.

## 1.5. Research Limitations

Research about dividend premium could have a large scope especially in the proxy that could be used for the dividend premium. In this research, dividend premium is measured by the difference of natural logarithm of average market to book ratio between dividend payers and non-payers.

## 1.6. Research Outline

This paper is divided into five main chapters in order to give specific information to the reader. Each chapter is designed for giving clear explanation about the topic. The chapter will be divided into a few subtitles which focus on certain problem. The systematic writing of this paper can be described as follows:

1) Introduction

First chapter is divided into six subtitles. All of the subtitles are background of the study, research problems, research objectives, research contributions, research limitations, and research outline. The explanation about dividend will be shortly described in the background of the study section. Problems of this research are simplified in the second subtitle. The purpose of this research which is designed to explain how investors demand affect company decision on dividend payment is described in the third subtitle. Contributions of this research will be shown in the fourth subtitles. The limitation of the research in fifth subtitle is created to make the research to be more focus in the effect of dividend payment on dividend payment decision. In the end systematic writing involves short summary of all chapters.

2) Review of Related Literatures

Second chapter will explain about specific details of theories and argumentations that could support the logic of the research such as dividend irrelevance theory, type of investor and their motivations, and market to book ratio. Previous research done by some experts and hypothesis will be explained in this chapter, while catering dividend theory will be used as the basic theories of analyzing the problem. The research model and operational framework will also be explain in this chapter.

3) Research Method

Third chapter will explain about the model being used in explaining the effect of dividend premium that indicates investors demand on the company decision about dividend initiation and omission. Specific model including both of dependent and independent variables will be shown in this chapter.

4) Result and Discussion

Fourth chapter will explain about the sample of the research object and also the result of data analysis of the regression of the model. In this chapter the output of the regression will be shown and the analysis will also be discussed.

5) Summary, Conclusions, and Recommendation

Fifth chapter will explain more about summary of data analysis, the whole summary of the paper, and the recommendation for other parties that will use this paper further.